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The International Legal Environment

This is Volume 52 in the series of studies commissioned as part of the research program of the Royal Commission on the Economic Union and Development Prospects for Canada.

The studies contained in this volume reflect the views of their authors and do not imply endorsement by the Chairman or Commissioners.



The International Legal Environment



JOHN J. QUINN
Research Coordinator

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When the members of the Rowell-Sirois Commission began their collective task in 1937, very little was known about the evolution of the Canadian economy. What was known, moreover, had not been extensively analyzed by the slender cadre of social scientists of the day.

When we set out upon our task nearly 50 years later, we enjoyed a substantial advantage over our predecessors; we had a wealth of information. We inherited the work of scholars at universities across Canada and we had the benefit of the work of experts from private research institutes and publicly sponsored organizations such as the Ontario Economic Council and the Economic Council of Canada. Although there were still important gaps, our problem was not a shortage of information; it was to interrelate and integrate — to synthesize — the results of much of the information we already had.

The mandate of this Commission is unusually broad. It encompasses many of the fundamental policy issues expected to confront the people of Canada and their governments for the next several decades. The nature of the mandate also identified, in advance, the subject matter for much of the research and suggested the scope of enquiry and the need for vigorous efforts to interrelate and integrate the research disciplines. The resulting research program, therefore, is particularly noteworthy in three respects: along with original research studies, it includes survey papers which synthesize work already done in specialized fields; it avoids duplication of work which, in the judgment of the Canadian research community, has already been well done; and, considered as a whole, it is the most thorough examination of the Canadian economic, political and legal systems ever undertaken by an independent agency.

The Commission's research program was carried out under the joint

direction of three prominent and highly respected Canadian scholars: Dr. Ivan Bernier (*Law and Constitutional Issues*), Dr. Alan Cairns (*Politics and Institutions of Government*) and Dr. David C. Smith (*Economics*).

Dr. Ivan Bernier is Dean of the Faculty of Law at Laval University. Dr. Alan Cairns is former Head of the Department of Political Science at the University of British Columbia and, prior to joining the Commission, was William Lyon Mackenzie King Visiting Professor of Canadian Studies at Harvard University. Dr. David C. Smith, former Head of the Department of Economics at Queen's University in Kingston, is now Principal of that University. When Dr. Smith assumed his new responsibilities at Queen's in September 1984, he was succeeded by Dr. Kenneth Norrie of the University of Alberta and John Sargent of the federal Department of Finance, who together acted as Co-directors of Research for the concluding phase of the Economics research program.

I am confident that the efforts of the Research Directors, research coordinators and authors whose work appears in this and other volumes, have provided the community of Canadian scholars and policy makers with a series of publications that will continue to be of value for many years to come. And I hope that the value of the research program to Canadian scholarship will be enhanced by the fact that Commission research is being made available to interested readers in both English and French.

I extend my personal thanks, and that of my fellow Commissioners, to the Research Directors and those immediately associated with them in the Commission's research program. I also want to thank the members of the many research advisory groups whose counsel contributed so substantially to this undertaking.

DONALD S. MACDONALD



At its most general level, the Royal Commission's research program has examined how the Canadian political economy can better adapt to change. As a basis of enquiry, this question reflects our belief that the future will always take us partly by surprise. Our political, legal and economic institutions should therefore be flexible enough to accommodate surprises and yet solid enough to ensure that they help us meet our future goals. This theme of an adaptive political economy led us to explore the interdependencies between political, legal and economic systems and drew our research efforts in an interdisciplinary direction.

The sheer magnitude of the research output (more than 280 separate studies in 70+ volumes) as well as its disciplinary and ideological diversity have, however, made complete integration impossible and, we have concluded, undesirable. The research output as a whole brings varying perspectives and methodologies to the study of common problems and we therefore urge readers to look beyond their particular field of interest and to explore topics across disciplines.

The three research areas, — *Law and Constitutional Issues*, under Ivan Bernier; *Politics and Institutions of Government*, under Alan Cairns; and *Economics*, under David C. Smith (co-directed with Kenneth Norrie and John Sargent for the concluding phase of the research program) — were further divided into 19 sections headed by research coordinators.

The area *Law and Constitutional Issues* has been organized into five major sections headed by the research coordinators identified below.

- Law, Society and the Economy — *Ivan Bernier and Andrée Lajoie*
- The International Legal Environment — *John J. Quinn*
- The Canadian Economic Union — *Mark Krasnick*

- Harmonization of Laws in Canada — *Ronald C.C. Cumming*
- Institutional and Constitutional Arrangements — *Clare F. Beckton and A. Wayne MacKay*

Since law in its numerous manifestations is the most fundamental means of implementing state policy, it was necessary to investigate how and when law could be mobilized most effectively to address the problems raised by the Commission's mandate. Adopting a broad perspective, researchers examined Canada's legal system from the standpoint of how law evolves as a result of social, economic and political changes and how, in turn, law brings about changes in our social, economic and political conduct.

Within *Politics and Institutions of Government*, research has been organized into seven major sections.

- Canada and the International Political Economy — *Denis Stairs and Gilbert Winham*
- State and Society in the Modern Era — *Keith Banting*
- Constitutionalism, Citizenship and Society — *Alan Cairns and Cynthia Williams*
- The Politics of Canadian Federalism — *Richard Simeon*
- Representative Institutions — *Peter Aucoin*
- The Politics of Economic Policy — *G. Bruce Doern*
- Industrial Policy — *André Blais*

This area examines a number of developments which have led Canadians to question their ability to govern themselves wisely and effectively. Many of these developments are not unique to Canada and a number of comparative studies canvass and assess how others have coped with similar problems. Within the context of the Canadian heritage of parliamentary government, federalism, a mixed economy, and a bilingual and multicultural society, the research also explores ways of rearranging the relationships of power and influence among institutions to restore and enhance the fundamental democratic principles of representativeness, responsiveness and accountability.

Economics research was organized into seven major sections.

- Macroeconomics — *John Sargent*
- Federalism and the Economic Union — *Kenneth Norrie*
- Industrial Structure — *Donald G. McFetridge*
- International Trade — *John Whalley*
- Income Distribution and Economic Security — *François Vaillancourt*
- Labour Markets and Labour Relations — *Craig Riddell*
- Economic Ideas and Social Issues — *David Laidler*

Economics research examines the allocation of Canada's human and other resources, the ways in which institutions and policies affect this

allocation, and the distribution of the gains from their use. It also considers the nature of economic development, the forces that shape our regional and industrial structure, and our economic interdependence with other countries. The thrust of the research in economics is to increase our comprehension of what determines our economic potential and how instruments of economic policy may move us closer to our future goals.

One section from each of the three research areas — The Canadian Economic Union, The Politics of Canadian Federalism, and Federalism and the Economic Union — have been blended into one unified research effort. Consequently, the volumes on Federalism and the Economic Union as well as the volume on The North are the results of an interdisciplinary research effort.

We owe a special debt to the research coordinators. Not only did they organize, assemble and analyze the many research studies and combine their major findings in overviews, but they also made substantial contributions to the Final Report. We wish to thank them for their performance, often under heavy pressure.

Unfortunately, space does not permit us to thank all members of the Commission staff individually. However, we are particularly grateful to the Chairman, The Hon. Donald S. Macdonald; the Commission's Executive Director, J. Gerald Godsoe; and the Director of Policy, Alan Nymark, all of whom were closely involved with the Research Program and played key roles in the contribution of Research to the Final Report. We wish to express our appreciation to the Commission's Administrative Advisor, Harry Stewart, for his guidance and advice, and to the Director of Publishing, Ed Matheson, who managed the research publication process. A special thanks to Jamie Benidickson, Policy Coordinator and Special Assistant to the Chairman, who played a valuable liaison role between Research and the Chairman and Commissioners. We are also grateful to our office administrator, Donna Stebbing, and to our secretarial staff, Monique Carpentier, Barbara Cowtan, Tina DeLuca, Françoise Guilbault and Marilyn Sheldon.

Finally, a well deserved thank you to our closest assistants: Jacques J.M. Shore, *Law and Constitutional Issues*; Cynthia Williams and her successor Karen Jackson, *Politics and Institutions of Government*; and I. Lilla Connidis, *Economics*. We appreciate not only their individual contribution to each research area, but also their cooperative contribution to the research program and the Commission.

IVAN BERNIER
ALAN CAIRNS
DAVID C. SMITH



This volume on the legal framework governing Canada's foreign economic relations, Michael Hart's monograph on the General Agreement on Tariffs and Trade (GATT) legal system and Douglas Johnston's monograph on the law of the sea are the products of the Royal Commission's Legal and Constitutional Research Program. The three volumes were designed to examine how existing legal arrangements for both multi-lateral and bilateral economic relations are likely to shape Canada's economic future. That future depends on the effectiveness of a global legal system designed to promote the openness, stability and dynamism of international markets. This system encompasses formal institutions such as the GATT, the International Monetary Fund and the United Nations Convention on the Law of the Sea. It also includes more specialized arrangements designed to regulate particular transactions or economic activities with significant transnational impact or consequences, such as foreign direct investment and the transfer of technology.

The authors who participated in the research program have attempted to evaluate the present international legal framework, and to assess the likely effects of future legal and institutional developments on Canada. The program was designed to educate a broad non-specialist audience in the basic legal norms and decision-making procedures regulating the most economically important aspects of Canada's links with the global economy: (a) trade in goods and services; (b) the utilization of marine resources and national regulatory powers applicable to coastal and offshore areas; (c) the transfer of technology and intellectual property rights; (d) Canada-U.S. economic relations; and (e) inward and outward flows of investment capital. The authors of these studies have also

examined the existing domestic arrangements for foreign economic policy making in Canada, and their work identifies and analyzes the basic options for designing domestic policies and institutions in response to the evolving global legal framework. Moreover, all the authors advance proposals for substantive and procedural reforms to the international legal system, and to domestic rules and processes.

The essay by Frank Stone and Carol Osmond in this volume surveys the institutional arrangements traditionally employed to conduct Canada–U.S. economic relations. Stone's experience as a career diplomat (now retired) in the trade field allowed him to observe the performance of international legal institutions from the standpoint of Canadian economic and political interests. His essay, co-authored with Osmond (a specialist in international economic relations), evaluates the major legal options for organizing bilateral economic relations from the perspective of the trade policy practitioner. Their essay summarizes an extensive legal, historical and political science literature on Canada–U.S. postwar economic affairs and advances important proposals for improving current legal arrangements governing bilateral trade and investment relations.

The essay by P. Soldatos focusses on the political consequences of economic integration, and the potential contribution of legal institutions in controlling the “spillover effects” of a Canada–U.S. free trade agreement on the Canadian political process. Soldatos, a political scientist, surveys the history of regional economic integration among the advanced industrialized nations during the postwar period, and analyzes the legal arrangements implementing the major free trade and customs union agreements. Based on his interpretation of the historical record and his conclusions concerning Canadian economic and political interests, the author attempts to formulate prescriptions concerning the design of appropriate legal institutions for a Canada–U.S. free trade area.

The essay by John Palmer (an economist) and Robert Aiello (a lawyer) analyzes the international and domestic laws governing transnational patent licensing. The authors criticize existing Canadian regulations that discriminate against foreign owners of patent rights and argue that domestic laws should be reformed to facilitate inward transfers of technology through patent licensing. Their essay also discusses the existing multilateral treaties and non-binding conventions that regulate national policies restricting the contractual transfer of technologies between nations. They conclude that a global regime guaranteeing non-discriminatory treatment, and promoting the transnational movement of commercially valuable technologies, holds the greatest potential advantages for Canada's future economic development.

My essay is designed to provide a broad overview of three essential aspects of the laws and institutions that shape Canada's foreign economic relations. The first part of the essay analyzes the legal framework

governing Canada's trade relations, both within the GATT system, and in relation to bilateral arrangements with the United States. The second part analyzes the laws and institutions regulating foreign investment policies and transfers of technology. The third examines the domestic legal framework which structures how both levels of Canadian government make foreign economic policy decisions. Each part advances proposals for redesigning the existing legal arrangements with a view to improving the economic welfare of Canadians.

JOHN J. QUINN

ACKNOWLEDGMENTS



Editing the monographs and essays in these three volumes was an intellectually rewarding task, not only because of the excellence of the authors' work, but also because of the many valuable exchanges and discussions with colleagues and friends who offered their assistance during the course of the Royal Commission's research program. Dean Ivan Bernier of the Laval law school deserves special mention. As the director of the research program, he helped to conceive the overall project and to design all the studies that appear in these three volumes. His intellectual and administrative contributions throughout the project were invaluable. Further special thanks are due to the Commission staff who performed an indispensable role in bringing these studies to completion, particularly my friend Jacques Shore who was an unflagging source of help and encouragement.

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Queen's University

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University of British Columbia

J.J.Q.



The International Legal Environment: *An Overview*

JOHN J. QUINN

Introduction: The Legal Framework for Canada's Foreign Economic Relations

This research study surveys the international legal norms and processes that govern national laws and regulations which affect imports and exports of goods and services, equity capital, and commercially valuable technologies. The main objective is to examine how this legal framework for international economic relations is likely to shape Canada's future economic development.

During the postwar era, Canada has consented to a large number of multilateral and bilateral treaties that have extended and elaborated the standards and procedures of an emerging "international economic law," a system of rules and processes designed to limit the power of national governments to intervene in international transactions for the purpose of discriminating in favour of their citizens or residents. This legal framework determines the formal terms of access that Canadian exporters have to foreign markets. These treaty obligations also impose constraints on both the substance and the form of the permissible tax, subsidy, and regulatory policies that are otherwise available to Canadian governments. Agreed limits on "beggar thy neighbour" or discriminatory national laws and policies can be justified in terms of the collective interest, shared by all trading nations, in the promotion of an efficient global market system — one that operates so as to allocate all available productive resources to their most highly valued uses. This widely shared human interest is advanced through the international legal principle of non-discrimination, which currently applies, at least to some extent, to most national taxes, subsidies, and regulations that affect

international trade in goods. The General Agreement on Tariffs and Trade (GATT) is a multilateral treaty which provides the formal rules and institutional framework for the non-discrimination regime. The GATT is Canada's primary trade agreement with 92 countries, including all of Canada's important trading partners except the Soviet Union, China, Mexico, Venezuela, and most OPEC countries.

The legal rules and procedures that are at present in place to control the national regulations which govern the international mobility of equity capital and technology originated from (and, for the most part, continue to derive their legal authority from) bilateral agreements among the industrialized nations of Western Europe and North America. During the postwar period, some progress has been made toward the "multilateralization" of norms of non-discriminatory treatment for foreign investors and technology owners among the Western developed nations, principally through the work of the Organisation for Economic Cooperation and Development (OECD). The developing nations have generally opposed the creation of an effective non-discrimination regime to facilitate the free movement of capital and technology, arguing that the primary impediments to the international transfer of investment funds and valuable technologies are privately created barriers imposed by Western multinational corporations. The United Nations Conference on Trade and Development (UNCTAD) has emerged as the primary institutional vehicle through which developing countries attempt to create new rules to govern the fields of foreign direct investment and technology transfer. Under the auspices of UNCTAD, negotiations are currently under way on two codes relating to the business practices of multinational enterprises. These codes propose broad new powers for direct national regulation of foreign-controlled corporations and for technology-licensing arrangements, which for the most part run counter to Canada's strong economic interest in a liberal international legal order for capital and technology flows.

This research study proceeds from the assumption that Canada's economic and political interests dictate strong support for the progressive elaboration of the non-discrimination principle under GATT and for its extension to national regulations restricting trade in services and constraining the international mobility of direct investment capital and technology. Virtually all students of Canadian economic policy agree that Canada's economic future will be shaped by the openness, stability, and dynamism of international markets for goods, services, capital, and technology. Access to foreign markets for Canadian producers and investors will depend mainly on their competitiveness and productivity; these qualities of industrial performance are in turn dependent on secure and relatively barrier-free access to a large high-income market for manufactured products. An outward-looking Canadian trade policy is the indispensable cornerstone of any plausible strategy for improving the competitiveness of Canada's secondary manufacturing sector.

Unrestricted access to new technologies and innovations in industrial processes will also be essential to the future success of Canada's manufacturing and resource industries. Markets for technology and equity investment are difficult to distinguish in practice, because most innovative firms and individuals prefer to retain control over the commercial application of their ideas. Most developed nations, including Canada, are currently engaged in liberalizing barriers to inward flows of equity capital and technology rights. The emerging problem for legal control is national competition to attract new investments in the industries that are most likely to benefit from anticipated breakthroughs in micro-electronics, biological engineering, and other rapidly developing technologies.

A relatively small and trade-dependent nation like Canada has little to gain, and a lot to lose, from a global "technology race" among the developed nations which would involve the competitive subsidization of chosen firms and industries. In order to reap the benefits of finishing first in a technology race, Canadian firms would require predictable access to export markets. Under the existing GATT rules on countervailing duties, market access can be curtailed through the imposition of retaliatory duties when subsidized imports cut into the domestic market shares of foreign producers or when they "materially retard" the development of a competing domestic industry. Canada's dependence on an outward-oriented development policy militates in favour of more effective legal arrangements governing national industrial subsidy policies and permissible forms of trade retaliation. The current conflict over industrial subsidies also illustrates the functional complementarity of trade policies, foreign direct investment regulations, and laws affecting imports and exports of technology. If Canadian trade policy is to be more outward looking, then securing the maximum economic gains from an export-oriented development strategy will necessitate adjustments in the regulatory treatment of foreign investors and technology owners.

Canadian foreign economic relations are also shaped by the nation's domestic legal institutions. The Canadian Constitution, with its division of economic regulatory powers between Ottawa and the provinces, is likely to have a substantial impact on the future direction of Canadian trade and investment policies. The crucial challenge of reaching a national consensus on foreign economic policies, and the legal mechanisms most likely to achieve a durable compromise among conflicting regional interests, is a second basic theme of this research study. If the removal or reduction of the provinces' non-tariff barriers is envisaged in future international negotiations, will formal provincial ratification of international agreements be legally required? Or does Ottawa possess the constitutional authority to bind the provinces in foreign economic matters without their consent? Aside from constitutional questions, what procedures for consultation and bargaining are likely to result in concerted action by both levels of government on foreign economic

problems? These complex questions are analyzed in the last part of this research study.

Organization of the Overview

This research study is organized in three self-contained parts. The first part consists of two sections, "Canada's Trade Relations and the Multilateral Legal Framework" and "Canada-U.S. Economic Relations." These sections analyze the legal framework governing trade policies, and they are meant to be read together. The following section, "The Regulation of Foreign Direct Investment and Transfers of Technology," analyzes the laws and institutions regulating foreign investment policies and the national regulations affecting technology transfers. The final section, "Federalism and Foreign Economic Relations," discusses the domestic constitutional framework that shapes Canada's foreign economic policies. Each of the latter two sections has been written to be entirely self-contained. Because of the diversity of the issues addressed, conclusions and prescriptive implications are drawn at the end of each section.

Canada's Trade Relations and the Multilateral Legal Framework

Canada's Current Trade Position

An analysis of the multilateral legal framework for trade relations, and its overall impact on Canada's trade policy options, should proceed from an appreciation of some basic facts concerning Canada's present role in international markets for goods and services. Canada's external trade has exerted a strong, almost dominating, influence over its economic past; the country's future prosperity depends on its ability to develop efficient firms that are capable of marketing technologically sophisticated goods and services in world markets.

Among the seven largest industrialized market economies, Canada (ranking seventh in Gross Domestic Product) is the leader in reliance on international markets as outlets for its goods and services. About 30 percent of Canada's current production of goods are exported, compared to an average export ratio of about 20 percent for the OECD nations as a whole.¹ In 1975, trade in goods and services accounted for less than 20 percent of domestic income; in 1984 it generated more than 30 percent of national income flows. By contrast, only about 10 percent of U.S. national income is attributable to international commerce, and the comparable statistic for Japan is about 15 percent. Canada is certainly not the only relatively small, trade-dependent, industrialized country. The Netherlands, Norway, and West Germany are all equally or slightly

**TABLE 1-1 Canada's Foreign Trade by Major Commodity Group,
Merchandise Trade in 1982, US\$ billion (fob)**

Commodity Group	Trade with U.S.		Total Trade with All Partners	
	Exports	Imports	Exports	Imports
Agricultural and food products	2.30	2.37	8.99	4.19
Raw materials	3.32	0.80	5.81	1.02
Ores and other minerals	1.16	0.93	3.73	1.26
Fuels	8.50	2.01	9.60	5.47
Non-ferrous metals	1.67	0.45	2.78	0.65
Total primary products	16.95	6.56	30.91	12.59
Iron and steel	1.10	.56	1.64	1.09
Chemicals	2.70	2.83	3.98	3.88
Other semi-manufactures	4.31	1.21	5.48	1.65
Total engineering products	19.13	23.73	23.24	29.01
Machinery for specialized industries	2.01	4.61	2.75	5.82
Office and telecommunications equipment	0.94	3.06	1.36	3.48
Motor vehicles	12.13	9.15	13.03	10.66
Other machinery and transport equipment	3.49	6.16	5.27	7.42
Household appliances	0.49	0.75	0.74	1.63
Textiles	0.12	0.61	0.29	1.13
Clothing	0.13	0.10	0.21	.84
Other consumer goods	0.77	1.90	0.96	3.09
Total manufactures	28.26	30.94	35.80	40.69
Total	45.43	38.23	66.98	54.26

Source: GATT, *International Trade 1982-83* (Geneva, 1983), Table A.18.

more dependent on trade for their economic prosperity. It should also be noted, however, that all three of these European nations participate in discriminatory regional trading arrangements (i.e., the Treaty of Rome and the European Free Trade Agreement) which provide their exporters with comparatively secure access to a transnational market of over 350 million people. As a "middle power" in the global trading order, Canada's postwar performance has been somewhat unusual, since apart from its automotive products trade with the United States, its relatively high degree of trade dependence has been achieved without the benefit of any explicitly discriminatory arrangements with principal or major trading partners.

In contrast to most advanced industrialized countries, Canada's exports are heavily oriented toward resources and resource-based products. Table 1-1 shows that exports of foodstuffs and inedible crude and fabricated materials account for about 65 percent of total outward goods shipments. Exports in the engineering products category, which encompasses the more technologically sophisticated manufactured products such as machinery, motor vehicles, and electronic equipment, comprise

approximately 35 percent of exported goods. In the six largest industrial nations of the OECD and also in Sweden, manufactured end products account for at least 50 percent of goods exports.² Sales of services to foreign clients contribute a much smaller share of Canada's export earnings. For example, in 1982 Canada exported about \$85 billion worth of goods and around \$12 billion worth of "tradable" services, such as banking, insurance, shipping and travel.³ Exports of tradable services currently account for about 4 percent of Canadian Gross Domestic Product (GDP). Approximately 70 percent of the Canadian workforce is now employed in the service sector, which accounts for about 65 percent of Gross National Product (GNP).⁴ Many types of service are not traded, because natural economic barriers arise from specialization and locational advantages. Nevertheless, many students of international business predict that, in the coming decades, technological advances will continue to expand the scope for trade in services and that this will be the major growth field in the global economy by the mid-1990s.⁵

Table 1-1 also shows that Canada is a net importer of engineering products, running substantial trade deficits in specialized machinery, electronic equipment, instruments, and computers. These data show that import penetration is very uneven in the manufactured end-products industries. Canadian exports of motor vehicles, transportation equipment, and telecommunications equipment are now roughly equal in value to the imports of these products. The trade deficit in manufactured goods tends to be concentrated in industries that have highly specialized production processes designed to exploit economies of scale (e.g., electrical products, metal fabricating, and printing) or those using custom-designed machinery and specialized equipment which is generally not available from Canadian suppliers.

Canada also incurs a trade deficit in tradable services; this deficit increased in absolute terms from less than \$1 billion in 1970 to almost \$3 billion in 1982, but its real value has held fairly constant as a share of GNP at around 1 percent.⁶ Services now account for about 25 percent of world trade in goods and services. Moreover, the rapid worldwide growth of the service sectors, in both developed and developing nations, is likely to present many opportunities for the future expansion of trade in business, financial, transportation, and communications services. However, most national markets in tradable services are now foreclosed by government procurement discrimination and by discriminatory entry controls and regulatory restrictions on the business activities of foreign-controlled enterprises. One of the most pressing legal and political issues now confronting the GATT contracting parties is the absence of any effective legal framework that would facilitate the liberalization of barriers to the services trade and would open up the functionally linked markets for those technologically sophisticated manufactured products that are usually sold in combination with services. The salience of this

**TABLE 1-2 Canada's Foreign Trade by Geographical Area,
Merchandise Trade in 1982, US\$ billion**

Geographical Area	Imports	Exports
United States	38.52	46.53
Japan	2.86	3.71
EEC	4.63	6.10
Other developed	4.27	6.16
Developing countries	0.31	1.00
Latin America	1.87	1.83
Far East	1.60	2.50
Total	54.06	67.83

Source: International Monetary Fund, *Direction of Trade Statistics Yearbook*, (Washington, D.C.: IMF 1983), pp. 116-17.

issue in Canada's multilateral and bilateral trading relationships is a theme discussed in several parts of this study.

The current regional distribution of Canada's external trade is heavily concentrated on the U.S. market. Table 1-2 shows that U.S. sales account for around 70 percent of total goods exports. Moreover, U.S. purchasers take around 80 percent of our exports of engineering products; Table 1-1 shows that motor vehicle exports to the United States alone account for almost one-half the value of Canada's current exports of engineering products. Virtually every significant Canadian exporting industry in every region of Canada's geographically specialized economy sells most of its output in the U.S. market (wood products, oil and gas, non-ferrous metals, fish and agricultural products, motor vehicles and parts, aircraft and parts, transportation equipment, telecommunications hardware and services, and semi-processed minerals).

On the import side, Canada is the United States' most important market, accounting for about 20 percent of U.S. exports. In 1983, U.S. exports to Canada were Cdn.\$66.3 billion, more than Japan at \$55 billion and four times as much as U.S. exports to West Germany and the United Kingdom combined. Richard Harris estimates that approximately 70 percent of Canadian imports of goods and services are made by large multinational corporations, perhaps 85 percent of which are either directly or indirectly owned by U.S.-based enterprises.⁷ Statistics collected in 1978 indicate that import transactions are highly concentrated in Canada; they showed that 50 firms accounted for almost 50 percent of all imports and that 35 of the 50 were controlled by foreign-controlled enterprises. A large share of the rapid postwar growth in Canadian exports of manufactured products is also attributable to the steady expansion of intra-firm trade, which currently accounts for about 57 percent of total goods and services exports.

None of Canada's other bilateral trading relationships account for as

much as 10 percent of our external trade. Table 1-2 shows that sales of goods and services to the European Economic Community (EEC) comprise less than 10 percent of total exports. European purchases of raw and semiprocessed resource products constitute the bulk of this trade, and Canada's share of the EEC market for these products has steadily declined during the past two decades.⁸ In the early 1960s, Western Europe accounted for about 25 percent of Canada's total exports of goods, concentrated in the agricultural and semiprocessed resource products areas.

Japan is currently Canada's third-largest export customer, and if recent trends continue, it will be our second most lucrative export market by 1990. Most of these exports involve resources or semi-processed materials; less than 5 percent of Canadian exports to Japan are in the engineering products category, while about 60 percent are raw or crude materials.⁹

Table 1-2 also shows that Canada's shipments to Latin America, the Far East, and all other developing countries amount to only a little more than 5 percent of total goods exports. Despite this small figure, trade with these nations has grown rapidly since the mid-1970s, and it is expected to continue to expand at a fast pace in coming decades.¹⁰ Nevertheless, Canadian producers of manufactured products and services have had relatively little success, with a few notable exceptions, in penetrating the markets of developing countries, when compared with the performance of Japanese, West German, and even Italian exporters. Webb and Zacher¹¹ have found that Canada and the United States were the only two major OECD countries to experience a growing trade deficit in manufactures with the newly industrializing countries during the 1970s; and while U.S. exporters of end products and services improved their relative performance during the early 1980s, Canadian exports to these countries continued to lag far behind those of the major OECD nations. Imports from the developing countries consist mainly of agricultural products and primary commodities, but since the 1960s there has been rapid growth in imports of manufactured goods, especially from the newly industrializing countries of the Pacific Rim and South America. Nearly half of the manufactured goods imported from developing countries are clothing products.¹²

Canada's external trade has grown steadily during the postwar period. A major feature of world economic development since 1950 has been the rapid growth of international trade; throughout most of this period, growth in trade has outpaced growth in production in the advanced industrialized countries, except for several relatively brief periods (most recently, 1979-81), during which growth in trade has only equalled or lagged behind growth in output.¹³ The proportion of the total world output of goods and services crossing international borders has more than doubled during the postwar period, from 11 percent of world output

in 1950 to 21 percent in 1980. Canada's relative share of the world export trade has fluctuated between 5 percent and 3.5 percent since the 1960s;¹⁴ but its share of world exports of manufactured products has been more stable, averaging about 4 percent.¹⁵ Some of Canada's trading partners have made large gains in their share of world trade during the postwar period, notably Japan and West Germany. Other developed nations, including the United States and the United Kingdom, have experienced sharp declines in their relative share of world export earnings, with the United States falling from 22 percent in 1950 to 10 percent in 1980. These shifts in relative trade shares have been buffered by the very rapid growth in the exporting sectors of all the developed economies. For example, U.S. exports as a proportion of GNP rose from 5 to 11 percent during the period 1950–80. Canada's exports as a share of GNP also doubled, jumping from around 15 percent to 30 percent.¹⁶

Canada's postwar trade performance has also been shaped by significant shifts in the composition and geographic distribution of its exports. Exports of industrial or manufactured products and of tradable services have grown rapidly since 1960, while those of unprocessed resource products have declined as a proportion of the total export trade. Since the mid-1960s, the primary source of export growth has been an increase in shipments of manufactured products, principally engineering products. Exports of manufactured end products nearly doubled in volume between 1971 and 1981, while exports of foodstuffs and of crude and fabricated or semiprocessed materials grew by about 40 percent during the same period.¹⁷

Shipments to the U.S. market have played a dominant role in this recent expansion of Canada's end-product exports. As mentioned earlier, the United States takes almost 80 percent of our total exports of engineering products. The major animating force in this rapid growth in Canada–U.S. trade has been the 1965 Automotive Products Agreement (Autopact), which achieved the rationalization of the Canadian and American auto industries. For Canada, the Autopact produced exports of around \$13 billion in 1982, compared with less than \$100 million in 1962.¹⁸ Notable increases have also been achieved in Canadian exports of industrial machinery and equipment, which in 1982 were valued at about \$8 billion, compared with about \$500 million in 1962.¹⁹ Canada's other key manufacturing sectors, based on agriculture, fishing, forest products, and mining (including mineral fuels), continue to generate large trade surpluses, but their combined share of total Canadian goods exports has declined during the postwar period, from around 70 percent in 1960 to about 50 percent in 1981.²⁰

To sum up, a basic trend in Canada's postwar export performance has been a decline, as a fraction of total foreign shipments, in exports of raw and semiprocessed resource products and a relative increase in exports of engineering products. Another salient development has been a height-

ened concentration by Canadian exporters on the U.S. market. U.S. buyers absorbed an increasing share of Canadian exports, especially of engineering products, during the period 1950–83. The unprecedented growth in the U.S. market share of Canadian exports in 1984 was more than the total of all Canada's exports of manufactured products to Japan and Europe.²¹

These two gradual, but sustained, shifts in the commodity composition and regional distribution of Canada's export trade have been driven by global and economic developments, which are likely to continue to exert considerable influence over Canada's export performance and industrial structure. In the resource-based sectors, such as forest products, non-ferrous metals, and minerals, there has been a sustained shift toward heightened competition from new lower-cost suppliers based in developing countries, since these suppliers often receive substantial subsidies from their home governments and enjoy preferential access to the markets of developed countries under legal arrangements that are sanctioned by the GATT. Many Canadian exporters of semiprocessed metal and mineral products are confronted with declining demand problems, created by the invention of new industrial materials and production techniques. Growth in the trade of agricultural products has also lagged, mainly because of the pursuit of self-sufficiency policies in the major importing countries and the entry of new exporters from developing nations. Tariff and non-tariff measures restricting trade in agricultural products have proved highly resistant to the efforts of both the United States and Canada to negotiate for improved market access within the GATT framework.²²

During the postwar era, there has been a shift in the composition of world demand toward a steady increase in the proportion of trade devoted to industrial products and services. Rapid growth in Canadian exports of manufactured products has been accompanied by a general and sustained increase in the trade in industrial products among all the GATT signatories. The contribution of the GATT legal framework to this unprecedented period of expansion in the trade of manufactured products is discussed in the next part of this section. Since Canada is a relatively high-income and trade-dependent industrialized nation, its economic future depends on whether its firms will be able to compete successfully in export markets for technologically sophisticated goods and services. While Canada's past successes as an exporting nation have been impressive, there is a substantial amount of economic evidence and opinion which casts doubt on the present ability of Canadian exporters to produce engineering products and services that are competitive, in terms of both price and quality, with the best that foreign firms can offer.

Three recent monographs (by Harris,²³ Lipsey,²⁴ and Whalley²⁵) on Canadian trade and economic development policy all advance the view that Canada now lies at a crossroads, in terms of the postwar evolution of

its industrial structure. New production technologies, such as automation and robotization, are shrinking the number of semiskilled jobs available in the traditional manufacturing industries and are increasing the adjustment pressures on workers and managers to retrain and upgrade their skills. Moreover, Japan and, more recently, the newly industrializing countries (NICs) have emerged as exporters of high-volume, standard-technology, manufactured goods that can be produced with relatively large inputs of low-skilled labour. This shift in competitive advantage began 25 years ago with the rise of Japan as an exporter of cheaper lines of clothing, textiles, and light manufactures such as toys and radios. Today, Japanese firms are on the leading edge in many of the high-technology industries, and the NICs of the Pacific Rim and South America have an acknowledged comparative advantage in steel, shipbuilding, automobile parts, and consumer electronics.

The range of products that can be competitively produced in the NICs is expected to broaden further as technologies become more widely diffused and as their workers become more highly skilled. In Canada, one estimate has put the number of jobs threatened by the NICs' current or near-term competitive pressure as being almost one-third of total manufacturing employment as of 1980.²⁶ Many of Canada's most labour-intensive secondary industries, such as clothing, textiles, footwear, and shipbuilding, have been declining since the mid-1960s, and they currently receive substantial tariff and quota protection from low-wage producers in the developing countries. With respect to trade policy, the main implication of these declining industries is that Canadian firms are unlikely to have many major successes in those world markets in which low labour costs confer a decisive competitive advantage. Other types of manufacturing that utilize relatively large amounts of semiskilled labour, such as the assembly of motor vehicles and other mass-produced consumer durables, are also likely to decline in importance as exporting sectors, unless new developments in the "robotization" of plants and other labour-saving technologies can neutralize the disadvantage Canada suffers because of its high labour costs.

In the more technologically sophisticated manufacturing industries, where product and process innovation and large-scale capital-intensive production methods are usually the most important factors affecting success in export markets, Canadian firms are handicapped, in competing with European, Japanese, and U.S. rivals, because of the small size of Canada's domestic market. With secure access to an internal market of only 25 million people, most of whom are dispersed in a thin band along the U.S. border, Canadian firms are prevented from exploiting the economies of scale and specialization which are the indispensable foundation for competitive success in global markets for sophisticated engineering products. For example, Japan possesses an internal market four times larger than Canada's, and its population is densely concentrated

on a few small islands; transportation and communications costs are therefore very small barriers to the integration of industrial activities.

These geographic and demographic constraints on scale and specialization in Canada also impede the development of export-oriented firms in the tradable service industries.²⁷ Outward-looking Canadian trade policies, and the international rules and procedures necessary to implement them, are the only plausible solution to this historic, but increasingly critical, impediment to the development of firms that are capable of becoming world-class competitors in global markets for engineering products and for technologically complex services. In short, future initiatives in Canadian trade policy should be principally directed toward the elimination of artificial or government-created barriers to export sales in both developed and developing countries.

With regard to foreign barriers to Canadian exports, it is generally thought that the pace of multilateral trade liberalization has slowed considerably since the conclusion of the Tokyo Round negotiations in 1979. Deep cuts in tariff barriers among the advanced industrialized nations have been achieved, but they have been accompanied by the increased deployment of non-tariff measures, such as voluntary export restraints, quotas, and unfair trade practice regulations. While some of the codes or agreements negotiated during the Tokyo Round have made modest advances in restraining these barriers, Canadian exporters continue to face a wide variety of penalty taxes, preferential government-procurement practices, and discriminatory product standards, to name only a few of the most prevalent restraints on access to national markets. Some of these trade barriers have arisen because of gaps in the subject matter coverage of the GATT rules, but many exist in spite of clear prohibitions or procedural constraints imposed by the multilateral legal framework.

The next part of this section surveys the major barriers that are likely to be confronted by Canadian exporters in future decades, and it attempts to prescribe the international rules and procedures that will be required to control them. This survey of the most economically important non-tariff measures is incorporated within an analysis of the strengths and weaknesses of the existing GATT legal system, from the standpoint of securing improved market access for Canadian exporters.

The Multilateral Legal Framework

The General Agreement on Tariffs and Trade (GATT) is a treaty with 92 signatories who have formally acceded to all the agreement's obligations, plus about 30 more associate members who derive more limited rights and duties from its provisions. The GATT council (and its administrative arm, the secretariat) implements and enforces the treaty's substantive rules and procedural requirements; it also organizes negotia-

tions aimed at amending the treaty. In the council, each full member has one vote on all important interpretive and enforcement decisions; most decisions are taken on the basis of a simple majority vote, but waivers of compliance and substantive amendments to the treaty require the affirmative support of two-thirds of the full membership.

It is important to appreciate that the council's amendment power cannot be employed to expand the subject matter coverage of the GATT or to modify its regulatory standards. Article XXX provides that even amendments which do not require unanimity, and which therefore become effective upon acceptance by two-thirds of the "contracting parties" (the formal legal title of the signatories acting as a collectivity), can nevertheless only be enforced "in respect to those contracting parties which accept them." Reform of the GATT must therefore take place through a complex process of negotiation among 92 developed and developing nations which share a diverse range of common and conflicting interests. Given the practical difficulties facing the achievement of unanimous consent within the council, it is not surprising that the multilateral or universalist character of the GATT legal regime has been eroded over the past several decades through the creation of regional trading agreements and non-tariff barrier codes, which are negotiated under GATT auspices but are only subscribed to by a small minority of the contracting parties (developed countries).²⁸

The GATT can be analyzed as a legal system or framework performing three interdependent functions:

- It provides a set of rules governing the procedures for trade negotiations and prescribing the legal consequences of promises to eliminate barriers to imports.
- It prescribes a code of state conduct to control a diverse range of legal instruments (taxes, subsidies, and regulations of various types) which can be employed to reduce imports or to increase exports.
- It establishes a dispute settlement process aimed at securing compliance with the treaty's substantive obligations.

In order to describe and evaluate the GATT, we shall analyze these three functions separately.

NEGOTIATING CONCESSIONS ON TARIFF AND NON-TARIFF BARRIERS

When in 1948 the GATT was created by its first 23 signatories, it was primarily designed to reduce national tariffs, and most of its procedural rules governing the conduct of negotiations were drafted with a view to facilitating the exchange of tariff concessions. The basic rules governing

tariff bargaining are fairly straightforward, and they have changed relatively little over the seven major negotiating conferences that have been sponsored by the GATT over the past 40 years.

The organizing principle of the bargaining process is the reciprocal exchange of promises to reduce or eliminate specific tariff rates. No signatory is legally obligated to lower any tariff, or even to refrain from raising any particular tariff rate, in the absence of an express undertaking to do so. These tariff concessions are usually made only during official negotiating conferences (or "rounds") and, in accordance with the customary principle of reciprocity, only in return for tariff cuts of equivalent value from the other contracting parties. Under the provisions of Article II, once a tariff concession is in force, the affected tariff rate is "bound" against increase above the agreed level. The value of bound tariff concessions is protected through ancillary rules, which are designed to prevent the substitution of other taxes or administrative charges which national governments might employ to discriminate against imported products. Moreover, the provisions of Articles III through xx, governing the principal non-tariff forms of trade protection (quotas, discriminatory government procurement practices, anti-dumping and countervailing duties, subsidies, and preferential state-trading activities), can be viewed as, in effect, legal constraints on non-financial substitutes for tariffs capable of "nullifying or impairing" the economic value of agreed concessions.

The multilateral or universal character of GATT tariff negotiations proceeds from the "most favoured nation" obligation found in Articles I and II. Under Article II, contracting parties are required not only to comply with their promises to make tariff concessions but also to apply those concessions to all contracting parties, not just to the government or governments with whom the concessions were actually negotiated. Under Article I, the "most favoured nation" clause (or non-discrimination obligation) applies to all tariffs, whether or not they are covered by a specific bound concession, and also to all other national rules or regulations governing the import or export of goods. The GATT permits a number of limited exceptions to the obligation to provide non-discriminatory treatment to imported products. Article XXIV exempts from the "most favoured nation" obligation those customs union and free trade agreements that satisfy certain minimum standards. Articles VII and XIV authorize the imposition of certain types of quotas, and anti-dumping and countervailing duties, on a discriminatory or country-specific basis.

After tariff concessions have been implemented, the GATT grants contracting parties the possibility of freeing themselves from their promises to reduce or eliminate tariffs. Article XXVIII authorizes the periodic renegotiation of bound tariffs; and Article XIX provides the possibility of unilateral escape from tariff concessions which, as a result of an

unforeseeable change in economic circumstances, result in serious commercial injury "to domestic producers of like or competitive products." In order to invoke the "escape clause" of Article XIX, contracting parties are required to offer compensation to trading partners whose exports are adversely affected by the withdrawal of pre-existing concessions; they must also withdraw concessions by imposing new tariffs or quotas on a "most favoured nation" basis and are not permitted to discriminate against exporters located in specific countries.

The GATT makes no general provision for negotiations on the elimination or reduction of non-tariff measures, and there were in fact no serious attempts to extend the rules governing these barriers until the Kennedy Round in the late 1960s. These non-tariff negotiations, and those conducted during the Tokyo Round in the 1970s, have been hindered by certain problems that make bargaining on non-tariff measures more complicated than the exchange of tariff concessions. Most non-tariff measures, other than explicitly protectionist laws such as quotas and "buy national" statutes, involve the exercise of administrative or executive discretion in order to impose discriminatory cost burdens on imported products, or to confer cost advantages on import-competing local producers.

Legal restraints on non-tariff measures must therefore take the form of highly detailed codes which prescribe objective criteria to govern the exercise of discretionary decision-making powers; these codes must also contain procedural safeguards, mandating written reasons, independent audits, and appellate review by an impartial body. Not only are such codes more difficult and time-consuming to negotiate than agreements to reduce tariff rates; they are also more difficult to enforce, because their provisions do not create rights and duties that are recognized by the domestic legal regimes of most national signatories. Instead, the codes must be implemented through national legislation and supplementary regulations, and these rules can be drafted to preserve broad discretionary powers which can be employed on a selective basis to discriminate in violation of the agreement.

Another problem arises from the fact that many types of non-tariff measure are not susceptible to a "bright line" prohibitory approach; rather, they necessitate an inherently subjective judgment on whether their discriminatory effects are unreasonable or unjustified in light of all the surrounding circumstances. The existing GATT dispute settlement machinery avoids this problem of "second guessing" national governments by accordin a strong presumption of factual and legal accuracy to the determinations of executive officials and administrative bodies. The problem of inadequate enforcement will be discussed later in this section, but first we shall summarize the GATT rules limiting non-tariff measures and shall attempt to identify their major deficiencies from the standpoint of Canadian trade objectives.

GATT RULES LIMITING TARIFF AND NON-TARIFF MEASURES

Tariffs

When Canada negotiated with 22 other nations in the first GATT round, the Canadian general customs tariff rates on most manufactured products ranged from 25 to 40 percent, levels that were high enough to prevent any appreciable quantity of trade in these goods. By 1987, when the Tokyo Round concessions are fully implemented, Canada's average tariffs on manufactures will be from 6 to 7 percent. Similar reductions in the tariffs of Canada's major trading partners have occurred as a result of the past seven GATT negotiating rounds. Currently, Canada has somewhat higher tariff protection, on average, than other advanced industrialized countries. By 1987, tariff rates on all imports will average 4 percent in the United States, 5 percent in the European Economic Community (EEC), and a little less than 7 percent in Japan.²⁹ In spite of the GATT's impressive achievements in reducing tariffs in the developed economies, imports of many types of agricultural products, semiprocessed resource products, and consumer goods remain subject to relatively high levels of tariff protection in most trading nations. Canadian exporters of food products and of semiprocessed goods derived from wood, minerals, and metals would be likely to benefit from the elimination or reduction of these tariffs. On the other hand, tariffs are no longer a significant impediment to trade in most technologically sophisticated manufactured products; for these goods and, of course, for all tradable services, which are not at present covered by the GATT, the current barriers to the expansion of world trade arise from a variety of non-tariff measures. The Canadian customs tariff and its impact on the competitive abilities of the secondary manufacturing industries will be discussed later, in the section titled "Canada-U.S. Economic Relations."

Quotas

Quotas, quantitative restrictions on imports, were the most important non-tariff barrier constraining trade among the developed nations at the time the GATT was drafted in the late 1940s, and the treaty contains a complex set of rules designed to control their use. Article XI prohibits contracting parties from imposing quotas unless special circumstances justify the invocation of one of three major exceptions to the rule. While now employed primarily by developing countries, the most frequently invoked justification for quotas during the first two decades of GATT's existence was the need to combat balance-of-payments problems. Article XI also permits the use of quotas in support of certain domestic agricultural programs which have the effect of raising domestic prices above the world market price, thus attracting large quantities of potential imports. This exception for agricultural products is currently invoked by Canada and by all its major trading partners — the EEC,

Japan, and the United States. Quotas currently constrain world trade in dairy and meat products, sugar, fish, and some cereals. While some progress was made during the Tokyo Round in liberalizing agricultural product quotas imposed by the developed nations, these barriers continue to prevent a huge potential volume of export trade for producers in nations, such as Canada, that have demonstrable comparative advantages.³⁰ (Existing American and Canadian quotas on agricultural products will be analyzed in more detail in "Canada-U.S. Economic Relations.")

The third major exception to the GATT rule prohibiting quotas is that developing countries are permitted to impose quantitative restrictions on imports in furtherance of their national economic development programs. Many developing nations maintain extensive import-licensing regimes that are applicable to a broad range of manufactured goods for the purpose of promoting the growth of indigenous industries. The continued existence of these quotas in many of the NICs has generated controversy within the GATT over the legal graduation of developing countries to "developed nation" status; but little progress has been achieved in defining the threshold of economic development which should be employed to distinguish those states that are not entitled to impose quotas for the purpose of promoting industrial growth through import substitution.

While the existing GATT rules on quotas suggest that developed nations are authorized to impose quantitative restrictions on non-agricultural products only for balance-of-payments reasons, most advanced industrialized nations maintain quasi-permanent quotas on manufactured goods such as clothing, textiles, footwear, steel, and consumer electronics. These quotas have in some cases been imposed in conformity with the general requirements of Article XIX: compensatory tariff cuts have been offered to trading partners disadvantaged by the quotas, and the quotas have been administered on a global or non-discriminatory basis. In the majority of instances, however, quotas or "voluntary" export restraints have been employed to limit imports originating in specific countries, usually the NICs and other developing countries that are experiencing the first stages of industrialization. Canada and its major trading partners have all been more or less equally guilty of failing to comply with their legal obligation to impose these quotas and other informal import restrictions on a non-discriminatory basis.

The political pressure for non-tariff protection originates from workers and investors in the declining industries of the developed economies; these influential coalitions have a strong preference for quotas and tariffs that preserve the status quo, rather than for explicit subsidies linked to relocation, retraining, and reinvestment. While the dynamics of representative democracy explain the prevalence of trade protection for

labour-intensive, regionally concentrated, manufacturing industries, the discriminatory methods used to provide such protection reflect the relatively weak bargaining power that the governments of most developing countries have when responding to demands for self-imposed cut-backs in their exports of manufactured products.

One important reason why developing countries have lacked influence in the domestic political processes of the developed nations is that most have not purchased large volumes of manufactured goods and services from Western firms. This is now changing in the United States, where aircraft and computer firms lobby vigorously against tighter quotas on textiles and shoes, because of their own growing sales to firms and governments in developing countries. In contemporary foreign trade relations, a nation's capacity to retaliate against restrictions on its exports is the primary determinant of the effectiveness of its GATT rights. In fact, the right to retaliate on a more or less tit-for-tat basis is the only remedy authorized by the GATT to redress a violation of its substantive obligations. The practical consequences of the absence of multi-lateral enforcement machinery in the GATT framework will be explored later in this study.

From the standpoint of Canadian interests, the weakness of the GATT's non-discrimination regime has probably conferred short-term economic advantages. If the United States were to impose quotas on steel, copper, or leather products on a non-discriminatory basis, the adverse impact on Canadian exports of these products would be substantial.³¹ Voluntary export restraints negotiated with the governments of specific developing countries operate to protect Canadian exporters, as well as U.S. domestic producers. Moreover, as Hart's recent study for this Commission demonstrates, the Canadian government has frequently ignored its GATT obligation to provide equal treatment to all imports of textile and clothing products originating in member nations, and it has also refused to offer compensatory concessions to developing countries that are harmed by its restrictions on their exports.³² A continuation of these policies, however, may result in more than off-setting disadvantages, partly because it could lead to additional restrictions on Canadian exporters' access to the markets of developing countries, and partly because it could further weaken the GATT non-discrimination regime.

Subsidies

Virtually all modern governments subsidize a broad range of economic activities. The benefits of some public subsidies (such as investment in education, public utilities, roads, etc.) are thinly and widely spread among national regions, industries, and individuals. Other subsidies are directed toward specific industries and firms, and are often linked to particular economic objectives, such as the maintenance of employment in declining industries or the attraction of new investment to the produc-

tion of technologically sophisticated goods and services. This second, more narrowly targeted form of subsidy can generate conflicts between trading partners when it has the effect of increasing exports or decreasing imports. Canadian governments, like those in other industrialized countries, have instituted a variety of subsidy programs, especially in the past two decades, as the Canadian economy has become more integrated into the world economy and has been exposed to more intense competitive pressures from abroad.³³ While declining manufacturing industries receive a large share of the total subsidy budget in most industrialized nations, there has been increasing emphasis on industrial policies aimed at "picking the winners" — promoting the development of firms in industries such as aeronautics, microelectronics, and biological engineering. A "technology race" among the advanced industrialized nations, conducted through the use of industrial subsidies, is not a contest that holds many advantages for a relatively small trade-dependent country like Canada. This is not only because Canada possesses a relatively small public treasury and a limited internal market; it is also because the GATT rules applicable to subsidies provide inadequate protection to Canadian exporters from punitive retaliation by the United States and the EEC.

The basic GATT provisions on subsidies have been consolidated in the *Code on Subsidies and Countervailing Duties*, which was concluded during the Tokyo Round. The code provides two basic legal mechanisms for controlling the trade effects of government subsidies. The need for two separate legal remedies arises from the fact that a subsidy which increases the production of a product in Canada, for example, can have two distinct adverse effects on U.S. producers of competing products. It can increase imports of the product into the United States and can also decrease U.S. exports to third-country markets. Nations whose import-competing domestic producers are able to prove commercial injury are entitled to levy countervailing duties on subsidized imports — penalty taxes calculated to offset the cost advantages conferred by foreign subsidies. When foreign subsidies result in a drop in export sales in third-country markets, the national government of the injured exporting industry is entitled to file a complaint with the code's committee of signatories, seeking either modification of the foreign subsidy or recognition of its legal right to retaliate against imports from the subsidizing nation. The code also contains a broad new prohibition on "export subsidies" granted on manufactured products. While the code fails to articulate a general definition of the key concept of "export subsidy," it does provide an "illustrative list" which incorporates such measures as income tax deductions and credits linked to income from export sales, government-supplied export credits and loan guarantees at below-market rates, and the rebate of tariff duties on imported components of exported products. The legal consequence of the code's absolute prohibition on export subsidies is

that contracting parties are no longer required to demonstrate material injury as a prerequisite to taking retaliatory action against imports originating in the subsidizing country.³⁴

In regard to countervailing duties, major problems have been encountered by Canadian exporters in the U.S. market. Prior to the negotiation of the GATT code in 1979, U.S. law imposed countervailing duties on subsidized imports, regardless of whether or not domestic producers could demonstrate "material injury" causally linked to the foreign subsidies. While the inclusion of a commercial injury test in U.S. trade legislation was one of the most important achievements of the Tokyo Round, U.S. producers of fish, wood products, urban transit equipment, and pork products have initiated major countervailing duty actions against Canadian exporters during the 1980s.³⁵ In the pork case, the U.S. Commerce Department has made a preliminary determination that Canadian price support programs are subsidies, including price stabilization payments under the *Agricultural Stabilization Act*. Other U.S. investigations in countervailing duty cases have involved a broad range of federal and provincial programs, such as unemployment insurance payments in the East Coast fishing industry, regional development assistance grants to a number of manufacturing firms, fishing boat construction loans, rates charged by the Canadian National Railways, and the prices charged to private lumber companies for standing timber owned by provincial governments.³⁶

Moreover, the U.S. Congress has failed to implement certain other important constraints on the availability of countervailing duty relief that are incorporated in the Tokyo Round code. For example, a majority of the commissioners of the U.S. International Trade Commission (the body that applies the "material injury" test in U.S. countervailing duty proceedings) have refused to consider whether the amount of subsidization on imported products was, at least to some significant extent, causally linked to the declining sales and lost profits of American competitors. They have looked only to whether the subsidized imports themselves have caused commercial injury — not to the relative causal contribution of the subsidy. This congressional refusal to implement the code persists, despite specific assurances by U.S. negotiators that the more stringent form of causation test would be adopted.³⁷

The United States is the only major trading nation that makes extensive use of its countervailing duty law. The addition of a "material injury" test has not prevented American industries from using countervailing duty proceedings to harass Canadian exporters with multiple actions and substantial litigation expenditures. The GATT code fails to provide any concrete definition of the types of foreign government program which may be challenged as countervailable subsidies; even unemployment compensation and retraining allowances to workers can be targeted for retaliation if they can be linked to an increase in exports.

The code also fails to impose any effective constraints on agricultural subsidies which adversely affect Canadian exporters. Export subsidies on many types of agricultural commodity have impeded the efforts of Canadian producers to expand their sales in Europe and in developing countries. Export subsidies on primary products are exempted from the code's *per se* rule against subsidies linked directly to export sales. The need for more effective legal restraints on agricultural subsidies, both for domestic production and for exports to third-country markets, is one of the most divisive issues confronting the GATT signatories, and it is likely to remain high on the agenda throughout the 1980s.³⁸

Government Procurement

National, regional and local governments buy for their own use everything from spacecraft to paper clips. For example, purchases of commodities account for about 40 percent of all government expenditures in the United States; in Canada, purchases by the federal and provincial governments now amount to over Cdn.\$60 billion annually. There are several ways to measure the size of the public sector, but the most commonly used involves the calculation of all "exhaustive expenditure" by government, defined to include the value of all resources consumed to provide the goods and services supplied by government. Based on this measure of the size of the government sector, the governments of Canada and the United States represent, respectively, approximately 18 percent and 16 percent of Gross Domestic Product.³⁹ Spending levels of this magnitude obviously represent significant potential export markets for both goods and services. The potential for trade in a wide variety of services, which are currently supplied exclusively by government departments and by quasi-independent corporations, is starting to attract serious interest from the private sector. Fred Thompson⁴⁰ has recently identified a large number of such service industries; he lists air traffic control, fire protection services, hospitals and health care, housing, postal services, prisons and correctional facilities, water supply and treatment, urban mass transit, and refuse collection services, among others, as future targets of opportunity for both domestic and foreign private sector suppliers.

National, regional, and local governments in all the developed nations maintain discriminatory procurement practices and ancillary regulations designed to limit public purchases of technologically sophisticated goods and services to domestic firms. The more blatant discriminatory techniques employed include specific statutory "margins of preference" (such as those contained in the "buy American" and "buy Canadian" acts), the explicit exclusion or disqualification of foreign bidders, and the refusal to publicize selection criteria for awarding government contracts. In addition to these overt strategies, the discretionary authority inherent in the power to choose between competing bidders on subjec-

tive non-price criteria provides broad scope for covert discrimination by purchasing officials against foreign bidders. For example, Quebec's purchasing policy establishes a 10 percent margin of preference for Quebec-based firms, but it also provides for an additional unspecified margin of favouritism for local firms when awarding them the contract would promote provincial "industrial development objectives." Most governments, at all levels, implicitly authorize systematic discrimination in favour of local suppliers merely by conferring broad discretionary powers on executive officials to award public contracts.

The effective control of covert protection in government procurement requires the deployment of legal techniques capable of constraining the discretion of purchasing officials: external audits, independent review bodies, mandatory reporting and "transparency requirements" such as the provision of written reasons for awarding contracts. Unfortunately, the GATT *Code on Government Procurement*, concluded during the Tokyo Round and now open for renegotiation after its fifth anniversary, has made negligible progress in the deployment of effective legal controls on discrimination in government purchasing. The code covers purchase agreements valued in excess of about U.S.\$200,000 by specific national departments, agencies and public corporations listed in separate treaty annexes. These lists of government organizations subject to the code differ from signatory to signatory, obviously reflecting painstaking negotiations to ensure reciprocal concessions of market access; the measure of reciprocity employed in the negotiation of the code was the value of each government entity's procurement budget, with some downward adjustment to reflect purchases under the \$200,000 threshold. The overall result of these extensive efforts to ensure strict reciprocity among the code's 28 developed country signatories was a much less ambitious agreement than had been anticipated at the commencement of the Tokyo Round. For example, less than 1 percent of the total Canadian procurement market (less than 5 percent of the federal procurement market), approximately Cdn.\$500 million annually, is currently covered by the agreement.⁴¹ Moreover, the United States refused to liberalize procurement by government-owned or controlled utilities in the power, telecommunications, and transportation industries — all of which are significant potential export interest to Canadian producers. All munitions and defense-related purchasing is also excluded from the code's coverage, although Canada-U.S.military procurement has been freed from any explicit discrimination since the conclusion of the Canada-U.S. Defense Production Sharing Arrangements in 1958. Public contracts for the purchase of services (defined generally by the code as contracts in which substantial quantities of goods are *not* also exchanged) are expressly excluded from the treaty's jurisdiction. Finally, state, provincial and local government entities have not been included in the code annexes which list the public organizations subject to the agreement.

For those government entities covered, the code prohibits any discrimination against prospective foreign suppliers, and contains regulatory guidelines designed to discourage various forms of covert favouritism for domestic firms. The code attempts to prevent discrimination by setting out detailed procedural safeguards which are aimed at making procurement processes more transparent and susceptible to monitoring by foreign suppliers and their home governments. In addition, the code has created a committee of signatories to administer the agreement and to conciliate disputes concerning its interpretation. This committee has not, however, had much success in achieving national compliance with the code's non-discrimination regime. In regard to Canadian implementation, Hart has observed:

There remains, however, a reluctance on the part of the ministers and government procurement officials to follow the practices that fully subscribe to the Agreement's principles. While the administrative manuals and procedures have been revised in the light of the Agreement's requirements, the success of foreign tenders for sales for which foreign and Canadian suppliers can compete has been minimal. Publicly stated government objectives continue to stress that government procurement will be given greater attention as an industrial development tool and Canadian content continues to be a major criterion in assessing the bids of various tenders.⁴²

The few Canadian firms that have attempted to penetrate the U.S. government procurement market have encountered similar problems. The U.S. programs aimed at promoting small and minority-owned businesses discriminate against Canadian suppliers. For example, in spite of the fact that military procurement is covered by the special bilateral treaty mentioned earlier, prospective defence contractors must demonstrate compliance with the following U.S. statutes: the "Buy American" Act; the Preference for U.S. Food, Clothing and Fibers Act; the Preference for Steel Plate Act; the Equal Employment Act; the Fair Labor Standards Act; the Prohibition of Price Differentials Act; the Small Business Act; the National Women's Business Enterprise Policy Act; the Resource Conservation and Recovery Act; the Davis-Bacon Act; the Walsh-Healy Public Contracts Act; and many others.

Both the Canadian and U.S. governments have identified the curtailment of discriminatory procurement practices as a top priority negotiating objective in the GATT talks which are expected to commence in 1986. What lessons might the negotiators learn from an assessment of five years of experience with the Tokyo Round code? The code's basic deficiency is that its dispute settlement process lacks any effective surveillance and compliance review machinery. Unsuccessful bidders are reluctant to complain publicly of discriminatory treatment because of their justifiable concerns that such action would nullify any possibility of future government business. Moreover the code's formal dispute process can only be invoked by national governments, and all the

signatories seem to have concluded that *sub rosa* non-compliance is more attractive politically and economically than standing up for the legal rights of their exporting industries.

In the context of the ineffectual legal regime created by the code, non-compliance is certain to be perceived as the superior strategy by national governments. As long as the contracting parties lack access to the legal techniques required to verify their mutual observance of the agreement's non-discrimination guarantee, it is unlikely that the code's prohibitions on discrimination will be respected to any significant extent. It would be irrational to cease discriminating against foreign bidders without some objectively verifiable assurance of reciprocal treatment. This is, in effect, the same basic difficulty which at present confronts negotiators of nuclear arms reduction treaties. In the absence of effective legal controls, little progress toward liberalization will be made unless the code's signatories demonstrate their good faith in the only objectively verifiable way possible — by awarding a significant amount of contracts to foreign suppliers. If the GATT contracting parties can agree to the use of the legal techniques required to control covert discrimination — effective monitoring and reporting procedures backed up by external review of specific procurement decisions — then they can create the framework of watchful trust that will be indispensable to the progressive liberalization of government purchasing policies.

Other Non-Tariff Measures

There are a great many other national laws and regulations which reduce, and artificially stimulate, international trade to the detriment of Canadian exporters. Product safety standards, anti-dumping regulations, customs rules concerning classification and valuation methods, and quota-licensing regulations constitute the most frequently used legal strategies for discriminating against foreign producers and for conferring benefits on domestic industries. In fact, the developed nations belonging to the GATT have negotiated separate codes to regulate the imposition of each of these non-tariff measures, similar to the codes on subsidies and government procurement.⁴³ All these measures, at least to the extent that they are intentionally employed for protectionist purposes, operate through the exercise of administrative discretion by national officials. The core problem regarding the international regulation of these measures is therefore the adoption of enforcement techniques that are capable both of constraining the scope for discretionary judgments and of making the discriminatory exercise of discretion more transparent to external review. These are, of course, the problems already discussed in relation to the GATT regulation of subsidies and government procurement; they will also be discussed in subsequent parts of this study. The existing GATT enforcement machinery, which falls far short of meeting these requirements, is analyzed below.

DISPUTE SETTLEMENT MACHINERY

The GATT procedure for settling disputes can only be initiated through formal complaints filed by one or more of the contracting parties. There is no provision in the treaty for multilateral surveillance and prosecutorial machinery, although signatories are obliged to notify all members about the tariff and non-tariff measures they impose, regardless of the conformity of these measures to GATT requirements. Under the procedures set out in Articles XXII and XXIII, a complainant is required to allege injury ("nullification or impairment") to its trading interests as a result of tariff or non-tariff measures imposed by the respondent member in violation of GATT rules. Article XXIII enjoins the disputants to consult in good faith for the purpose of settling their differences. If a compromise is not achieved, the contracting parties appoint a panel of impartial experts, usually drawn from among the national representatives to the GATT, to investigate the trade complaint, to formulate findings on disputed points of fact and law, and to make recommendations aimed at achieving a mutually agreeable settlement.

Panels have tended to view their role as one of conciliation, even to the point of refusing to enter findings of fact in disputes over the economic consequences of tariff and non-tariff restrictions, i.e., whether an industry suffered "material injury," or whether a putative customs union agreement would free "substantially all the trade" between its signatories. GATT panels have usually avoided any review of the factual bases for national administrative and executive decisions. The result of such deference has been to deprive the GATT's legal standards of any determinate meaning; after 40 years of application, fundamental concepts such as "serious injury," "more than an equitable share," and even "subsidy" have no generally accepted definitions that are specifiable in the sort of objective criteria required to provide a certain benchmark for the legality of national decisions.⁴⁴ Although many of the provisions of the Tokyo Round codes were designed to clarify the substantive content of long-standing GATT norms, the committees created to implement the codes have, like the GATT panels, failed to undertake any systematic review of national compliance. In fact, during the six years since the conclusion of the Tokyo Round, not a single formal complaint has been filed to invoke the formal machinery for settling disputes established by the non-tariff barrier codes.

When the contracting parties vote to accept their panel's recommendations, which is usually the case, they will issue a formal declaration requesting the disputants to negotiate a compromise solution along the lines suggested in the panel's decision. If the contracting parties recommend that the respondent withdraw or modify the challenged measures, and if the respondent refuses to do so, the complaining nation may be authorized to retaliate against the respondent's exports. Retaliation against imports originating in the respondent nation must be limited to

tariff surcharges or quotas designed to have trade-restrictive effects that will be roughly equivalent to the tariff or non-tariff measures imposed in violation of GATT rules. The GATT makes no provision for multilateral trade retaliation as a sanction for non-compliance.

Since retaliation, or self-help, is the only sanction available to promote compliance with the treaty, it should not be surprising that enforcement of GATT norms has largely depended on the retaliatory capabilities of signatories adversely affected by other members' failures to live up to their legal obligations.⁴⁵ It is clear that the GATT non-discrimination regime has failed to protect Japan, the NICs, and many developing countries from the illegal quotas and voluntary export restraints that have been levied against their manufactured products in Western European and North American markets. Japan has never filed a formal complaint invoking the GATT process, and yet the EEC maintains significantly higher illegal barriers to Japanese imports than either the United States or Canada does.⁴⁶ This differential in respect for GATT norms is attributable to Japan's ability to threaten more costly retaliation against North American industries. Since Japanese imports of EEC products are comparatively trivial, Japanese threats to retaliate would be unlikely to cause the potentially affected EEC industries to lobby vigorously on behalf of Japanese exporters.

Conclusions: The GATT and Canadian Interests

The GATT rules can only succeed by altering the balance of political power between these national interest groups that favour and those that oppose further progress toward a liberal market-oriented approach to organizing global trade. A legal framework with the modest ambition of regulating the use of retaliation can make a positive contribution to the strengthening of national political coalitions working for trade liberalization. If serious departures from international rules could be followed by fairly certain and predictable retaliation, there would be more compliance among those advanced industrialized countries that have volumes of two-way trade large enough to make a serious difference in their national political processes. Canada and the United States have the largest bilateral trading relationship in the world, and each is the other's largest trading partner. Most students of the GATT would agree that the United States and Canada have been the most enthusiastic supporters of the multilateral legal framework and that they have also made greater efforts to comply with its norms, at least in respect to their bilateral trade. Canada may be comparatively more dependent on its exports to the United States and thus more vulnerable to retaliation than the United States, but its large volume of imports from a wide variety of U.S. industries creates a large number of strong allies who are likely to be supportive of Canadian interests. As long as retaliatory capability remains the primary determinant of a nation's access to foreign

markets for its exporters, Canada and the United States share the best prospects for creating effective legal constraints on protectionist government policies.

The challenge of enforcing the GATT rules, and creating a jurisprudence of objective standards for national conduct, is the most serious problem confronting the contracting parties. There is little point in negotiating new rules on trade in services, or a significant liberalization of government procurement markets, without more effective enforcement machinery. Multilateral surveillance of national tariff and non-tariff measures, and compliance audits conducted by a new GATT body created to promote observance of the treaty's standards would be a step in the right direction; but the current prospects for such reforms appear remote, even among the advanced industrialized nations.

It seems likely, therefore, that the serious trade conflicts described in this section will continue to divide the major industrialized members of the GATT in the foreseeable future. While Canada has something to gain, and certainly nothing to lose, from continuing its efforts to strengthen the multilateral legal framework, there is a limit to what it can accomplish in the absence of a strong consensus among the EEC, Japan, and the United States on a concrete agenda for reform. Canada cannot afford to wait indefinitely for improvements in the effectiveness of the GATT framework. The acute adjustment problems currently confronting Canada's manufacturing industries necessitate immediate action to secure barrier-free access to a much larger high-income market for its exports.

Canada-U.S. Economic Relations

Introduction

While the GATT legal framework has been the primary vehicle for the conduct of Canada-U.S. trade relations during the postwar era, the governments of both countries have recently expressed interest in the prospect of some form of bilateral agreement to liberalize trade in goods and services. The economic and political consequences of North American trade liberalization will be shaped to a significant extent by the legal or institutional forms employed to implement and administer this new arrangement. An analysis of some concrete ideas concerning the practical operation of a bilateral trade agreement should also help to clarify the advantages and dangers of seeking closer commercial ties with the United States. This part of the research study aims at describing the legal options for the effective management of Canada-U.S. economic relations over the next quarter century.

The analysis is developed by focussing on the three essential structural components of a bilateral trade agreement. The first question that

must be addressed is the appropriate procedure for organizing the bilateral bargaining process. Should the negotiating agenda be limited to trade barriers that affect a limited number of selected industries? Or should it encompass all significant tariff and non-tariff measures? If an across-the-board approach to trade liberalization is chosen, should certain industries or sectors nevertheless be exempted from the barrier reduction process?

The second crucial issue for designing a workable bilateral arrangement concerns the form and content of the treaty's substantive provisions governing the removal or reduction of specific trade barriers. Should a Canada-U.S. agreement attempt to limit or eliminate retaliatory customs duties on dumped or subsidized trade? Should a bilateral treaty permit safeguard, or "escape clause," measures when trade liberalization results in substantial commercial injury to particular industries?

The third problem concerns the design of the institutional structures and procedural mechanisms for administering the arrangement and resolving disputes concerning its proper interpretation. Should a Canada-U.S. trade agreement be implemented by an independent inter-governmental body? Should disputes arising under the treaty be subject to some form of binding arbitration at the instance of either party?

These are some of the major questions analyzed in this part of the research study. The role of provincial and state governments in the negotiation and implementation of a bilateral trade arrangement is an issue that will be addressed in a later section of the study.⁴⁷ The effective management of Canada-U.S. economic relations will depend on our future success in designing new decision-making structures that facilitate federal-provincial consensus on trade policy issues. Thus, the discussion that follows takes the existence of such cooperative structures for granted.

The three basic features of a bilateral trade agreement, as listed above, should be analyzed within the context of Canada's basic policy objectives in pursuing such negotiations with the United States. The most important objective is to contract for barrier-free access to the U.S. market under a legal arrangement that guarantees the durability of these trading privileges against future political and legal challenges.⁴⁸ Investor confidence in the permanence of North American trade liberalization is essential. Without effective legal commitments of predictable market access, Canadian industry will be unlikely to invest the large amounts of capital that will be required to rationalize, retool, and expand existing productive facilities in order to capture the maximum benefits from freer trade.

Future legal and political challenges to a bilateral arrangement are certain to arise because of the nature of the U.S. political process. Trade policy in the United States is formulated and administered through

highly decentralized decision-making processes, which tend to augment the political power of relatively small but well-organized producer groups such as industrial unions and trade associations.⁴⁹ One legal consequence is that private enforcement procedures are available for a wide range of U.S. federal regulatory laws. This fragmentation of enforcement authority is exemplified by the legal arrangements for providing contingent protection against imports which cause commercial injury to domestic industries. Legal proceedings involving countervailing duties, anti-dumping duties, and other forms of emergency relief from import competition can be initiated by U.S. firms on a virtually unilateral basis, with no downside risk or penalty if their allegations of injurious or unfair competition cannot be proved.⁵⁰ Since the mid-1970s, American industries faced with strong competition from imports have employed these legal remedies to harass Canadian and other exporters. For example, since 1979, four countervailing duty actions have been brought against the Canadian East Coast fishing industry, and all four proceedings were eventually dismissed as non-meritorious.⁵¹

The costs to Canadian industries of defending against these actions are far from trivial. In the recent softwood lumber countervail action, the estimated legal and lobbying costs for the Canadian defendants were reported to have exceeded \$1 million.⁵² Moreover, the threat of these costly and unpredictable administrative and judicial proceedings deters investment in the most efficient plant and equipment, when the commercial viability of such facilities depends on secure access to the entire North American market. Since most of the industrial adjustments necessitated by freer trade will have to be shouldered by Canadian workers and investors, any legal uncertainties concerning the effectiveness of the treaty's access guarantees are likely to be much more harmful to Canadian industries than to their American counterparts. A comprehensive free trade agreement would be of such critical importance to the direction and pace of Canadian industrial development that the federal government should insist on a legal arrangement which covers all the major potential problems with precise and detailed rules and procedures, in order to provide credible guarantees to prospective investors.

A second key bargaining objective in any bilateral talks with the United States is the preservation of the multilateral legal framework: the GATT, the International Monetary Fund, and other multilateral economic institutions. The preceding part of this research study discussed the substantial advantages that have accrued to Canada as a result of the postwar creation and strengthening of the GATT legal system. It is essential that any move toward freer trade in the North American market be complementary to the norms and procedures of the multilateral framework. If a free trade agreement between Canada and the United States were to undermine the perceived legitimacy and operational effectiveness of the GATT legal structure, Canadian exports to the

EEC and the Pacific Rim nations could be jeopardized. For many Canadian industries, this weakening of GATT access guarantees might be too high a price to pay for improved access to the U.S. market. There is, however, no convincing legal reason to believe that a Canada-U.S. trade arrangement would weaken or undermine the GATT framework. Article XXIV of the GATT expressly authorizes the creation of "free trade areas" under certain specified conditions:

- The treaty incorporating the free trade agreement must cover "substantially all the trade" between the signatories.
- The arrangement must eliminate all barriers and restrictions, including all major tariff and non-tariff measures applicable to existing and future trade among the signatories.

Past GATT rulings and panel reports on the application of Article XXIV suggest that a valid "free trade area" must cover approximately 80 percent, by value, of the commodities which are being traded by the parties when the arrangement comes into force.⁵³ Moreover, the GATT contracting parties have been very permissive in applying these legal requirements in past cases involving the EEC and the European Free Trade Association.⁵⁴ In several instances where the Article XXIV conditions could obviously not have been satisfied, such as the European Coal and Steel Community and the Canada-U.S. Autopact, the GATT signatories have agreed to provide complete waivers on a virtually unconditional basis.⁵⁵ Thus, it seems highly probable that Canada and the United States could negotiate a mutually acceptable bilateral arrangement that would satisfy the legal requirements for full compatibility with the GATT.

The third primary objective in negotiating on the legal design of a free trade arrangement should be the containment of the unwanted political side effects of closer trade links with the United States. From a Canadian standpoint, the most persuasive argument for freer trade with the United States is strictly an economic one; that is, Canadians could become up to 10 percent wealthier as the result of a comprehensive and effective free trade arrangement.⁵⁶ Since American gains in per capita wealth are certain to be much less, the United States might attempt to exploit its increased economic leverage in order to secure compliance with foreign or national security policies which conflict with Canada's national interests. A second related concern is that the removal of bilateral trade barriers is certain to intensify the competitive pressures on the majority of Canadians, whether they are employed in export-oriented sectors or in businesses operating exclusively in the domestic market. A general and significant squeeze on prices, wages, and costs is certain to produce political initiatives aimed at altering federal and provincial tax and regulatory policies so that they will conform with their U.S. counterparts.⁵⁷

Soldatos's exhaustive study⁵⁸ on the political and cultural side effects of closer trade ties with the United States concludes that some increase in U.S. political influence, exercised either by government officials or by private interest groups, is certain to occur at both levels of Canadian government. Since Canada will have greater economic stakes than the United States in preserving an effective free trade arrangement, it is essential that the treaty should contain legal constraints that would prevent either nation from using its economic leverage under the agreement to influence or dictate the other country's policies in non-trade areas. There is a serious danger that in future disputes between the two governments involving issues wholly unrelated to bilateral trade, the United States might be tempted to threaten the abrogation or partial suspension of the agreement in order to secure a compromise that would be relatively more favourable to its interests. Canada must anticipate this risk and must negotiate for strong legal safeguards that limit the power of either nation to use the trading relationship to influence other government policies which do not directly impact on bilateral commerce.⁵⁹ This widely shared concern about the expansion of U.S. influence in the Canadian political process militates in favour of a new bilateral legal framework with mandatory and legally binding enforcement procedures.

The Negotiating Format and Agenda

Before meaningful bilateral talks can begin, Canada and the United States must agree on the substantive issues that will be discussed and the general target or objective of the negotiations. These framework or procedural issues are, however, usually impossible to negotiate until the parties have fully disclosed the barrier reductions which they are prepared to offer.⁶⁰ For strategic reasons, it could be a mistake for Canada to announce specific bargaining objectives before the United States reveals the quality and quantity of the trade concessions it will bring to the negotiating table. Nevertheless, an assessment of these framework questions, and how their resolution would be likely to shape the outcome of the negotiations, provides a logical starting point for analyzing the legal options for structuring Canada-U.S. trade relations.

Since the late 1970s, both governments have conducted a number of departmental and parliamentary studies on the appropriate scope and subject matter of bilateral trade negotiations.⁶¹ Most of these studies have given extensive consideration to the option of negotiating bilateral agreements designed to liberalize trade in a limited number of specific industries. Moreover, in January 1984, Trade Minister Gerald Regan and Trade Representative William Brock initiated a joint departmental study on the reduction of trade barriers in four sectors: computer services, steel, farm machinery, and urban transit equipment.⁶² Although the

results of this study have not been disclosed, and although neither government has taken a clear position on the issue, there appears to be continuing widespread support for a sectoral approach to North American trade liberalization.

An industry-by-industry approach to freer trade is attractive because of its gradualist or incremental character. Since the consequences of major economic and legal changes cannot be accurately forecasted, step-by-step reform is a valuable strategy for limiting the inevitable downside risks, principally by constraining the scope of potential investor and employee adjustment problems. A sectoral negotiating format would constrain such problems, and this could be important for budgetary reasons if new adjustment programs for displaced workers necessitated substantial increases in public expenditure.

There are, however, several strong arguments against aiming any future bilateral negotiation toward the ultimate conclusion of a limited number of sectoral agreements. A bilateral treaty that removed tariff and non-tariff barriers in only a few industries might be challenged as a violation of GATT's Article XXIV, which requires that a valid free trade agreement must remove barriers to "substantially all" the trade between the signatories. If sectoral free trade resulted in significant trade diversion from other GATT signatories, those nations would have an incentive to initiate a formal panel proceeding. The GATT contracting parties have taken a permissive view of such preferential trading arrangements as the European Economic Community and the European Free Trade Association, which excluded large sectors of economic activity, such as agriculture, from the scope of their coverage.

Canada and the United States might be able to defend their sectoral agreements by arguing that after the concessions of the Tokyo Round are fully phased in, at least 80 percent of their bilateral trade will already have been freed from all restrictions. Therefore, since a North American free trade area would already exist in fact, there could be no serious objection to allowing the implementation of further reductions in barriers on an industry-by-industry basis. This defence would require a formal joint declaration that a free trade area existed under GATT law.⁶³ An alternative strategy for validating a number of sectoral agreements under GATT law would be to apply for a waiver under Article XXV. The United States obtained an explicit waiver of compliance with the requirements of Article XXIV when the Autopact was negotiated in the mid-1960s. Since Article XXV provides that a formal waiver must be approved by a two-thirds vote of the GATT contracting parties, it might prove difficult to use this strategy to validate a series of sectoral agreements, given the political conflicts that divide the current GATT membership.

A second and far more important objection to sectoral bargaining focusses on the pragmatic politics of organizing winning political coalitions.

tions in support of bilateral trade liberalization. A sector-by-sector format impedes the intersectoral exchange of trade barrier concessions. Firms that are doing business in sectors targeted for negotiations will enthusiastically support or oppose bilateral free trade, according to their perception of the balance of competitive advantage in their particular industry. Political resistance from domestic industries which stand to lose from bilateral free trade will tend to eliminate sectors where the economic welfare gains from liberalization would be particularly large from the bargaining agenda. In addition, a bilateral negotiation focussing on specific sectors would be unlikely to generate strong support from employees in sectors which also had significant export potential but were excluded from the bargaining.⁶⁴ Moreover, there is less likelihood of organizing sufficient support from thinly spread interest groups, such as consumers, because of the relatively small size of the potential benefits from liberalizing bilateral trade in a small number of industries.⁶⁵

A third argument against the sectoral format is that it would be difficult to liberalize bilateral trade using this approach, without at the same time increasing the incidence and severity of intersectoral distortions in a partially integrated North American market.⁶⁶ These distortions will arise if end products are traded free of barriers, while trade in products used as major inputs remains subject to restrictions. For instance, free trade in wine might not be sustainable without free trade in grapes if U.S. grape growers possessed substantial cost advantages over their Canadian rivals.

A fourth disadvantage of sectoral bargaining is that it would involve a piecemeal approach to certain bilateral problems that affect most, or a large proportion of, the industries engaged in transborder trade. For example, industry-by-industry bargaining would be an unwieldy procedure for dealing with the crucial issue of contingent protection. It might be difficult to negotiate sector-specific exemptions from, or limitations on, U.S. and Canadian unfair trade practice regulations if industries excluded from the bargaining viewed them as discriminatory special treatment.

To sum up, negotiations aimed at a comprehensive liberalization of barriers to trade in goods and services would be consistent with GATT legal requirements and would avoid or mitigate the practical disadvantages of a sectoral negotiating format.

Three basic types of across-the-board agreement have frequently been discussed as plausible options for closer economic links between the United States and Canada: a common market (which, for the purposes of this study, need not be distinguished from the broader notion of "economic union"), a customs union, and a free-trade area. These alternative arrangements need to be defined with some degree of precision if their advantages and disadvantages are to be compared.

A common market arrangement incorporates three basic compo-

nents: free movement of goods and services among member countries; common tariffs and the harmonization of other policies that affect trade with non-member countries; and free movement of capital and labour among member countries. A common market is therefore the most complete form of transnational economic integration which preserves the political sovereignty and independent status of member countries.⁶⁷ It may also, but need not, incorporate additional elements that increase the degree of economic integration among the member countries. For example, the members might form a monetary union, which would necessitate the creation of a common currency and a common central bank to manage monetary policies.

However, a common market arrangement would not be compatible with Canada's desire to preserve its autonomy over trade and economic relations with third countries. A common market requires a uniform set of commercial policies that are applicable to non-member nations. Canada has often chosen to pursue external trade policies that have been in conflict with U.S. initiatives. For example, Canada continued to maintain trade relations with Cuba and China after the United States had adopted legislation prohibiting commerce with both countries. Moreover, a common market would necessitate the harmonization of a diverse range of other policies and programs, besides those concerned directly with external trade, because it requires the "free movement" of capital and labour among member states.⁶⁸ Thus, Canada would no longer be able to implement immigration policies and foreign investor regulations that were incompatible with U.S. federal and state policies. Because of Canada's relative size and its weaker bargaining leverage, it could not exert any substantial influence over decision makers in Washington unless it succeeded in forming effective alliances with American interest groups who held shared views and objectives; and on some policy questions of major importance to Canada, such as the regulation of foreign-controlled firms, U.S. allies might well be virtually nonexistent.

Under a customs union arrangement, Canada and the United States would be required to remove all tariff and non-tariff measures applicable to their bilateral trade in goods and services, and they would also be compelled to agree on a joint set of commercial policies governing imports and exports from third countries. A common external trade policy would, for the reasons outlined above, be formulated primarily in response to the demands and priorities of U.S. interest groups. For example, a customs union would not permit Canada to reduce protection against third-country imports unless it could persuade the United States to take similar action. Since a customs union requires a high degree of consensus on external commercial policies, it would be more likely to generate a large number of intergovernmental conflicts that could undermine progress toward the liberalization of bilateral trade.⁶⁹

The free trade area is the type of across-the-board arrangement which is most often discussed in relation to Canada-U.S. economic integra-

tion.⁷⁰ A free trade agreement permits each member to impose its own regulations on transborder movements of labour and capital; each member country may also levy its own taxes and impose its own regulations on goods originating in non-member countries. Basically, a free trade agreement commits its signatories to allow goods and services produced in a member country unrestricted access to their own markets, unless the treaty provides for specific exceptions. From the standpoint of Canada's negotiating objectives, this type of arrangement is superior both to the common market and to the customs union. Any less comprehensive legal arrangement runs the risk of consigning Canadian investors and employees to an internal market of insufficient size to permit efficient restructuring; and any more encompassing type of agreement is likely to be politically unacceptable because of the constraints it would impose on Canada's capacity to deploy independent policies.⁷¹ A free trade area also has the advantage that it is relatively easier to expand to include new members, because it avoids the costly process of negotiating the harmonization of commercial and allied policies that has to precede the admission of new countries to a customs union or common market.

The choice of a general or comprehensive free trade arrangement would not preclude special treatment for a limited number of industries or sectors. A review of past interpretations of Article XXIV of the GATT indicates that free trade agreements excluding up to 20 percent of the total trade in goods among member countries have been approved by the contracting parties — or, in some instances, not expressly disapproved.⁷² Since GATT does not regulate trade in services, Canada and the United States could choose to negotiate service trade issues on an industry-by-industry basis. Canada could choose to bargain for the total or partial exclusion of several industries and sectors in which the complete removal of trade barriers might generate special economic or social problems. Four such industries will be briefly considered here, not because they are the only types of business which might require exceptional arrangements, but because they provide good examples of the kind of problems that are likely to be encountered in the course of the negotiations. The four sectors are agriculture, traded services, cultural products, and energy and other non-renewable resources.

A substantial volume of potential trade in agricultural products is currently precluded by quantitative restrictions which are imposed by both the United States and Canada.⁷³ Quotas in Canada apply to eggs, poultry, dairy products, and some meat products, and are administratively linked to domestic supply management programs which are designed to promote national self-sufficiency in these products. Canada also imposes a number of seasonal tariffs, applicable to fresh fruits and vegetables, which are designed to protect less efficient Canadian producers from U.S. competition. The elimination or reduction of these

trade barriers would require the negotiation of harmonized supply management and farm subsidy policies with U.S. federal and state governments.⁷⁴ Since these negotiations will have to be conducted on a product-by-product basis, the liberalization of agricultural trade is likely to be technically complex and politically controversial. These special difficulties may justify the deferral of free trade for agricultural products which are currently regulated by quota schemes in either country.

During the 1980s the U.S. government has aggressively promoted the liberalization of trade in services, particularly in transportation, communications, banking, insurance, engineering, architecture, and business consulting. It is certain that the reduction of barriers to bilateral trade in services will be a high-priority negotiating objective for the current U.S. administration. Many of the existing restrictions on trade in services involve entry controls on foreign-owned businesses.⁷⁵ Canada controls or prohibits the entry of U.S. firms into the transportation and financial services industries; and the federal cabinet's prior approval powers under the former *Foreign Investment Review Act* have been used to prevent American business-consulting firms from establishing Canadian subsidiaries.⁷⁶ A recent study by the U.S. government indicates that the removal of existing Canadian barriers in the financial, transportation, and business-consulting industries would be likely to result in significant penetration of the Canadian market by American firms.⁷⁷ On the other hand, many Canadian firms in these same fields are reported to be capable of substantial incursions into U.S. national and regional markets.⁷⁸

In spite of the large potential for expanding bilateral trade in services, there are several difficulties which are likely to hinder a comprehensive approach to liberalizing this trade. There is a great deal of uncertainty about the outcome of a major negotiation focussing on trade in services, in part because of the novelty of the issues and the lack of any experience in bargaining on them. Although both the U.S. government and the Canadian government have recently completed exploratory research projects on trade in services, there is still relatively little objective information on the economic consequences likely to result from the removal, or significant reduction, of existing national barriers.⁷⁹ The U.S. federal and state governments maintain entry controls and similar restrictions, which operate to exclude foreign entrants or to limit their allowed share of national or state markets in many service sectors such as banking, transportation, and communications.⁸⁰ Any useful analysis of Canadian and U.S. barriers must therefore focus on the national regulations applicable to each particular service industry on both sides of the border.

In both countries, government purchasing policies that discriminate in favour of local suppliers are a major impediment to trade in engineering and construction services, while cost-increasing regulations applicable

to the transborder flow of information limit potential trade in financial and business-consulting services.⁸¹ Free trade in transportation services will require the harmonization of divergent national laws regulating price competition, service quality, and other equally complex issues. Since most service industries are governed by regulatory barriers that are virtually unique and are tailored to the peculiar characteristics of the business, future bilateral negotiations will have to be organized on a sectoral basis. While it may be possible to secure agreement on some general rules that would be applicable to all service sectors (for instance, a code on government purchasing practices), industry-by-industry arrangements will be necessary to establish more detailed standards for national regulations and to provide for specialized bilateral bodies to oversee implementation.⁸² The general issue of designing legal arrangements to liberalize bilateral trade in services is also closely related to the problem of achieving cooperation between Ottawa and the provincial governments. The federal-provincial aspect of trade relations will be analyzed in this research study's final section, "Federalism and Foreign Economic Relations."

Canada's cultural industries such as publishing and the performing arts would also be likely candidates for special treatment under a comprehensive bilateral free trade agreement. Both the federal government and the provincial governments currently provide import protection, as well as favourable tax treatment and other direct subsidies, for Canadian cultural products and activities. This is at least partly because of a widely held belief that our domestic market is not large enough to sustain them on a commercially viable basis.⁸³ Ottawa has also legislated a number of protectionist measures designed to increase the creation and dissemination of Canadian culture. For example, the so-called Canadian content rules promulgated by the Canadian Radio-television and Telecommunications Commission, and the income tax regulations which bar Canadian advertisers from deducting the cost of advertising on U.S. border stations, protect Canadian producers and broadcasters from U.S. competitors.⁸⁴ While the maintenance of these protectionist laws and regulations would obviously be inconsistent with a free trade regime, Canada is likely to insist on explicit treaty provisions authorizing the support of its cultural industries with public funds, in order to compensate for the handicap imposed by the small size of our domestic market.⁸⁵

The argument for special protection hinges in part on the judgment that access to the American market on a guaranteed basis would not lead to a substantial increase in exports of Canadian cultural products; but if this argument were sufficient to secure an exemption from free trade, then there would be a multitude of qualified candidates for special treatment. Rather, the persuasive argument for allowing continued subsidization of the cultural industries is that they provide "public goods"

which are undersupplied by the market. Moreover, the EEC and European Free Trade Association treaties permit subsidies for cultural activities (e.g., the United Kingdom supports the British Broadcasting Corporation), and these special exemptions for the cultural industries are not a controversial issue in European trade relations.⁸⁶

A fourth sector that may require exceptional treatment in a bilateral free trade agreement is natural resources. From a Canadian standpoint, the principal concern will be whether a free trade agreement would preclude the imposition of production quotas or export controls in industries such as oil, natural gas, uranium, and water, in which security of supply might become a critical issue in future decades.⁸⁷ Moreover, national tax and subsidy policies applicable to petroleum products will need to be harmonized in order to permit free trade, but this seems likely to occur in the near future because of the Mulroney government's recent commitment to phase out the "two price" system in the energy sector.⁸⁸ The most difficult bargaining problems are likely to be encountered in formulating rules to govern export controls on non-renewable resources such as oil, scarce minerals, and perhaps, in the future, water. Article XX of the GATT permits signatories to maintain non-discriminatory measures "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with regulations on domestic production or consumption." If Canada's right to impose export or production controls is to be retained, the United States is likely to negotiate for some legal guarantee of access to future resource supplies. The free trade agreement could create preferential access guarantees for American resource consumers while also providing that Canada could limit future exports in order to satisfy reasonable domestic requirements.⁸⁹ Disputes are certain to arise over the meaning of "reasonable" domestic requirements, and it will be essential for the treaty to provide for some fair process for resolving these interpretive and fact-finding problems. The options for dispute settlement under a bilateral free trade arrangement are analyzed in a subsequent part of this study.

Substantive Provisions

Article XXIV of the GATT directs that the parties to a bilateral preferential agreement must remove "all barriers" to substantially all their trade in goods as a precondition to the creation of a valid free trade area. Therefore a Canada-U.S. free trade agreement should not only provide for the elimination of tariffs, quotas, and other measures of explicit protection, but it should also provide for the removal of all significant non-tariff barriers that give indirect or implicit protection to domestic producers. Moreover, for strategic reasons, it is essential that Canada should obtain effective restraints on U.S. contingent protection mea-

sures, such as anti-dumping and countervailing duties; an agreement aimed only at eliminating tariffs would not provide the security of access required by Canadian industries. In discussing the substantive provisions of a bilateral agreement, it is helpful to distinguish between three general types of laws and regulations which currently restrict Canada-U.S. trade: tariffs, contingent protection measures, and a residual category comprised of all other non-tariff barriers. Since both Canadian and American legal systems differentiate the legal instruments used to implement these three types of restrictive measures, it will be necessary to draft specific treaty provisions governing each one.

TARIFFS

After the Tokyo Round tariff cuts have been fully phased in, which should occur by mid-1987, about 80 percent of Canada's exports to the United States will enter duty free, and an additional 15 percent will enter at duties of 5 percent or less.⁹⁰ Thus, after 1987, only about 5 percent of our existing exports to the United States will enter at duties exceeding 5 percent ad valorem. These statistics suggest that tariffs will be an insignificant impediment to bilateral trade in goods; but this impression is somewhat misleading, since the data reflect existing, not potential, bilateral trade flows. In other words, these statistics obscure the fact that many commodities are not currently traded, because U.S. tariffs effectively neutralize the cost advantages of Canadian producers. U.S. tariffs remain relatively high on such products as rapid-transit equipment, railroad equipment, and petrochemicals; Canadian manufacturers of these goods are reported to be cost competitive with American and other foreign suppliers.⁹¹ In short, there will still be a significant number of Canadian manufacturing firms that will be deterred from exporting to the United States, even after the Tokyo Round cuts have been fully implemented. Moreover, in some resource sectors, U.S. tariffs set at only 2 or 3 percent will significantly discourage new investment in Canadian mines and plants.⁹²

From the standpoint of U.S. exporters, the elimination of post-Tokyo Round Canadian tariffs is likely to confer substantial benefits on many manufacturing industries. While the overall or average incidence of the Canadian tariff is likely to be below 5 percent by 1987, the average tariff on dutiable goods will be 9 to 10 percent, with a significant number of these tariffs falling within a range of 15 to 25 percent.⁹³ Moreover, in 1985 Canada increased a number of tariff rates when it introduced the new system of customs valuation prescribed by the Tokyo Round agreements; these rate changes are designed to maintain equivalent degrees of protection as the new valuation procedures are implemented. In terms of existing Canada-U.S. trade, Canadian tariff barriers are approximately five times higher than those prevailing in the United States. These

relatively high levels of tariff protection in Canada have failed to stimulate new import substitution industries on a significant scale. Nor have they promoted the growth of world-class exporters. Moreover, these tariffs continue to burden industrial users and consumers who rely on foreign inputs and products. For example, the tariffs on computers and electrical machinery discourage manufacturers from converting to more efficient production processes.

An effective procedure for cutting both nations' tariffs to zero will be an essential component of a bilateral free trade agreement. GATT Article XXIV authorizes a "reasonable" period of time for the phasing-in of free trade arrangements. It is very unlikely that a free trade agreement could be concluded before the Tokyo Round tariff cuts are fully implemented in 1987. If a free trade arrangement were to be in place in 1990, the successive tariff cuts could be stretched over a ten-year period and Canadian border protection would not be fully removed until the turn of this century. Assuming that this scenario is plausible, the main problem for Canadians would not be the losses incurred on existing assets (given the maintenance of prevailing interest rates), but rather the challenge of exploiting new opportunities to orient the next generation of capital investment toward cost-efficient production for export.

If both sets of national tariffs were reduced by the same absolute amount on an annual basis, the U.S. tariff would be eliminated much sooner than Canada's. A Canadian tariff rate of, for example, 10 percent could be reduced by 1 percent per year over the ten-year phase-in period. The generally much lower U.S. counterpart tariff of, for example, 5 percent could also be reduced at the same rate of 1 percent per year so that it would disappear in five years. The fifth to the tenth years of the phase-in period would provide Canadian producers with the temporary competitive advantage of free entry into the American market while retaining declining levels of protection in their domestic market. The justification for conferring this advantage on Canadian exporters is that their rapid expansion during the phase-in period would be necessary in order to provide jobs for workers displaced from industries which would be required to contract as a result of free trade.⁹⁴

Another strategy for softening the impacts of tariff cuts would be to time duty reductions to coincide with buffering movements in the exchange rate. Given the continuation of significant and frequent fluctuations in the exchange rate, a scheduled Canadian tariff cut of 1 percent per year could be delayed until a time during the year when the Canadian dollar had decreased in relative value. The argument for providing Canadian producers with temporary special advantages over their U.S. rivals is that they will bear the brunt of the adjustment costs resulting from bilateral free trade. Since most American industries are, on average, ten times larger than their Canadian counterparts, the transitional impacts from bilateral free trade will in general be far less severe in the United States.

Since each member of a free trade area retains control over its commercial policies toward non-member countries, an effective free trade agreement must include certain technical provisions designed to accommodate the economic consequences of tariff rate differentials among the members. Producers located in non-member or third countries have an incentive to export to the free trade area by first shipping their goods into the member country with the lowest external tariff and then shipping them into other members' markets on a duty-free basis. In order to control this "trade deflection" effectively, Canada and the United States would have to negotiate rules of origin, which would provide, in effect, that only goods produced or partially produced within the free trade area would qualify for duty-free treatment.

Rules of origin may be liberal or strict in terms of the national content requirements specified for products entitled to free entry. A liberal system permits a substantial proportion of the value of goods qualifying as "free trade area products" to originate from production activities carried out in non-member countries. For example, the European Free Trade Association (EFTA) treaty contains a liberal set of origin rules, which generally provide that a product qualifies for free entry if at least 50 percent of its export price is attributable to production activities conducted within the free trade area.⁹⁵ The EFTA treaty originally provided a relatively strict rule of origin, which required that 70 percent of a product's export price had to originate from within-area producers. This was because the EFTA signatories initially feared that sizable deflections of trade would occur unless strict origin rules were applied. When actual trade diversion proved to be negligible after the treaty's implementation, the signatories agreed to adopt the more liberal 50 percent standard. The liberal rule has worked relatively smoothly, considering the absence of serious complaints of unfair competition due to differential tariff rates among members.

One factor that reduces the potential for trade deflection is the absence of major tariff rate differentials on inputs (i.e., raw materials and semiprocessed products) among members of the free trade area.⁹⁶ Liberal rules of origin are less likely to cause friction when tariff levels on inputs employed by most producers of tradable goods are relatively uniform among member countries. Since most Canadian and American customs duties on raw materials and semifabricated products are uniformly low or are nonexistent, it is likely that a liberal system of origin rules would provide sufficient protection against trade deflection resulting from a bilateral free trade agreement.⁹⁷

CONTINGENT PROTECTION MEASURES

In addition to provisions governing the phased withdrawal of tariffs and rules of origin, a free trade treaty will also have to deal with a diverse range of non-tariff measures which currently restrict bilateral trade flows

between Canada and the United States. As indicated earlier, Canada's exports to the U.S. market are vulnerable to several different types of non-tariff restriction: the particular policy rationales and legal procedures applicable to these non-tariff mechanisms will need to be considered when designing an effective trade-liberalizing arrangement. U.S. non-tariff measures that currently affect Canadian exports can be divided into two basic categories. In the first are measures of contingent protection, principally anti-dumping duties, countervailing duties, and safeguard or "escape clause" actions. In the second category are other laws or regulations, which (either expressly or through administrative practice) operate to protect domestic producers by imposing discriminatory cost burdens or other competitive disadvantages on goods of foreign origin; such measures include government purchasing policies, product quality and safety standards, and government subsidies to local industries.⁹⁸

The legal instruments employed to provide contingent protection can be further subdivided into those that govern "fair" trade (e.g., safeguard actions), and those that govern certain types of "unfair" trading practices (e.g., anti-dumping and countervailing duty proceedings, and a number of related patent and anti-trust offences). This legal distinction between regulations governing fair and unfair trade arises from GATT rules which authorize signatories to retaliate with penalty duties on imports that benefit from foreign government subsidies and on imports that are "dumped," that is, sold at export for prices lower than those prevailing in the exporter's home market.⁹⁹ U.S. firms which can prove material or non-negligible commercial injury (e.g., lost sales, declining profits, etc.) as a result of subsidized or dumped imports are entitled to demand the imposition of penalty duties, which are calculated to neutralize the unfair competitive advantage favouring the imported products. The most serious concern with these unfair trade practice regulations is that they have frequently been employed to harass Canadian exporters and to discourage the growth of potential export industries in Canada.¹⁰⁰ Moreover, recent legislative and administrative changes in U.S. countervailing duty law have expanded the definition of unfair subsidies on which penalty duties can be assessed; these changes have had a disproportionate impact on Canadian imports such as softwood lumber, hogs, and fish.¹⁰¹ These measures also pose a serious threat to federal regional economic development subsidies and related provincial programs throughout Canada.

Safeguard action (or "escape clause" action, as it is referred to under U.S. law) differs in several significant aspects from contingent protection measures aimed at unfair trade. The GATT provides that temporary protection against imports which cause "serious injury" to the sales or profit levels of domestic firms is legitimate, provided that the protective duties or quotas are imposed on a "most favoured nation" basis and that

compensatory duty reductions or other concessions are extended to countries whose exporters are adversely affected by the safeguard action. Proceedings for "escape clause" action can be initiated by private individuals or by groups (i.e., trade associations, labour unions, etc.); but in the United States the final arbiter is the President, who possesses broad discretion to grant or deny safeguard protection under U.S. legislation.¹⁰²

During the 1970s and 1980s, U.S. presidents have provided safeguard relief by negotiating "voluntary export restraints" with exporting countries whose industries were principally responsible for injurious levels of imports to the U.S. market.¹⁰³ While this practice probably violates the GATT's legal requirements for valid safeguard action, it has generally been highly beneficial to Canada, because our exporters' share of the U.S. market is usually too small to qualify as a principal source of commercial injury to U.S. competitors. For example, recent safeguard measures designed to protect the U.S. copper and steel industries were imposed only on exporters located in "principal supplier" nations, with the result that Canadian exporters of these products were unaffected by the measures.¹⁰⁴ Given the existing thrust of U.S. foreign trade regulations, the unfair trade practice rules, particularly the countervailing duty law, are a significantly greater threat to Canadian exporters than safeguard measures.

While the U.S. has made several complaints about procedures employed in the enforcement of Canada's anti-dumping law, contingent protection through the regulation of allegedly unfair trade is not a substantial impediment to U.S. exports to the Canadian market. Canada has never imposed countervailing duties on U.S. imports, and most Canadian anti-dumping actions against U.S. products have been rather insignificant in terms of the value of trade affected.¹⁰⁵ Canada's reluctance to use retaliatory penalty duties against U.S. industries results from its heavy dependence on U.S. export markets. Since U.S. exporters are much less dependent on uninterrupted access to the Canadian market, Canada has virtually no chance of improving its bargaining power by engaging in a retaliatory trade war with the United States. A bilateral agreement constraining the ability of U.S. producers to initiate retaliatory measures against Canadian firms must therefore be a top-priority negotiating objective for Canada.

How might a Canada-U.S. agreement limit the trade-restrictive effects of existing unfair trade practice regulations? It seems improbable that any U.S. administration would agree simply to exempt Canadian goods from the possible application of countervailing and anti-dumping proceedings. A complete reciprocal ban on these retaliatory measures would require a complementary agreement, setting out both nations' obligation to prevent subsidies or dumping that would cause material commercial injury to import-competing industries. The effective control

of dumping within a free trade area should not be a difficult problem, because unrestricted transborder exchange should minimize intercountry price differentials. Moreover, both countries possess relatively similar domestic laws regulating price discrimination that adversely affects market competition (i.e., predatory price-cutting).¹⁰⁶ The harmonization of these national laws to create a uniform code of anti-trust rules for the free trade area might provide a mutually acceptable substitute for national anti-dumping regulation.

From a Canadian viewpoint, the main advantage of substituting anti-trust measures for anti-dumping duties would be procedural. Anti-dumping duties are assessed early in the enforcement process, and these taxes must be paid, or equivalent security posted, when imported goods enter at customs. Anti-trust rules, on the other hand, are enforced either through civil litigation or through administrative penalty or criminal proceedings launched by the government. Neither civil nor criminal procedures require defendants to prepay prospective damages or fines, or to post surety bonds to cover these contingent liabilities. Because the government collects its penalty (albeit, on a "provisional basis") months or sometimes years in advance of the completion of the proceedings, anti-dumping measures will generally tend to be a more potent deterrent to trade than anti-trust regulation.¹⁰⁷

The complete removal of countervailing duties is certain to raise more difficult negotiating problems. One option would be to link the abolition of retaliatory duties to a general agreement limiting the subsidy policies of both nations. Bargaining on permissible and proscribed forms of subsidization would be complicated by the fact that Canadian subsidies tend to take the form of direct grants to specific firms, while U.S. governments provide aid to domestic industries through more indirect means, e.g., tax benefits, public provision of infrastructural facilities, defence expenditures which generate new products and production technologies, etc.¹⁰⁸ Since U.S. subsidies are more diffusely spread across industries, it is difficult to measure them and assess their financial impact on specific firms. Moreover, even if it was possible to reach agreement that particular types of subsidy would be permitted, it would be unlikely that either nation would accept a categorical obligation not to retaliate against such subsidies regardless of their competitive impact on domestic firms.¹⁰⁹ For example, both the United States and Canada have implemented subsidy programs aimed at retraining workers displaced from declining industries, and it seems plausible that both nations would agree to permit these and similar subsidies under bilateral free trade.¹¹⁰ If retraining subsidies were paid directly to Canadian employers in the aircraft or computer industries, and if these industries' export sales to the U.S. market subsequently grew by a significant margin, the U.S. administration would receive heavy political pressure to take remedial action. Therefore any workable agreement on subsidies must include a general obligation not to grant subsidies which result in serious

or unreasonable disruption in the other nation's markets. Under such a broad legal principle, disputes over interpretation and economic fact will be inevitable; appropriate arrangements for resolving such disputes will be discussed in a subsequent part of this study.

A related drafting option for limiting unfair trade practice regulations would be to amend existing national legislation to provide that Canadian and U.S. products would not be included with the products of other countries for the purpose of determining whether a domestic industry had suffered "material injury" (the key prerequisite for the imposition of anti-dumping and countervailing duties). In other words, subsidized imports from Canada could only be penalized if it was proved that the Canadian products, considered independently of other imports of the same product, had created a material level of commercial injury to the U.S. industry. Canada has won several significant countervailing duty cases in which Canadian goods were alleged to be the principal source of injury, since U.S. firms were unable to prove the existence of a material level of lost sales or profits attributable to the subsidized imports.¹¹¹

A third option for constraining the protectionist impact of national unfair trade practice regulations is to shift their enforcement from national administrative bodies (i.e., the International Trade Commission and the new Canadian Import Tribunal) to some new intergovernmental body established by the free trade agreement.¹¹² Under this approach, the agreement could provide for the creation of a standing tribunal to adjudicate both on anti-dumping complaints and on countervailing duty complaints originating from industry or labour groups in either country. This transnational body would, in effect, assume the administrative and quasi-judicial functions that are currently performed by agencies in Ottawa and Washington. All decisions would be taken by an essentially judicial panel, comprised of appointees from both nations and a certain number of neutral members selected from third countries. An effective arrangement would probably also require the creation of an administrative support staff with commercial, economic, and legal expertise. This staff could be assembled from federal, provincial, and state officials, seconded from government departments with responsibility for trade, economic development, and external affairs. An intergovernmental panel and staff composed in this way would ensure the impartial application of unfair trade practice rules and would thus tend to mitigate their protectionist impact.

In February 1984, Canada and the United States signed an agreement providing for advance notification of safeguard proceedings initiated in either country.¹¹³ This agreement requires advance notice of at least 30 days before safeguard restrictions are imposed, as well as consultation on measures to mitigate adverse impacts on bilateral trade, assuming that the justification for the safeguard action is injurious imports from third countries. In the recent past, the United States has been very cooperative in finding ways to shelter Canadian producers from safe-

guard restrictions, usually by negotiating export restraint agreements with the principal supplying countries while leaving Canadian exports unrestrained. Nevertheless, it is certain that an agreement aimed at providing secure market access for both Canadian and American producers would have to impose some significant restraints on the use of safeguard protection.

One might assume that the best solution would be the complete dismantling of safeguard protection applicable to goods originating in either country. The basic economic purpose of a free trade arrangement, certainly from Canada's standpoint, is to create positive incentives (i.e., a relatively barrier-free North American market) for significant industrial restructuring. Thus, the continued availability of safeguard protection to firms injured by imports would substantially undermine the main purpose of the free trade arrangement. On the other hand, a free trade treaty which contained no escape clause, and which thus offered no prospect of escape or temporary reprieve for injured domestic industries, might not be acceptable to a large number of politically influential producer groups in both nations.¹¹⁴

One alternative to a complete suspension of safeguard measures would be to amend existing national safeguard legislation to provide that such protection could only be imposed if Canadian or U.S. goods were determined to be the "primary cause" of serious injury to domestic firms; that is, exports originating in either country would be assessed independently of other exports in measuring the competitive impact on domestic firms. Another possibility would be to retain safeguard measures but to transfer their enforcement (that is, the key determination whether the industry petitioning for relief has in fact suffered a serious degree of injury) to a transnational panel or body established by the free trade agreement. As with anti-dumping and countervailing duties, the choice of drafting options on safeguard measures turns, in large part, on designing appropriate institutions for implementing the agreement and for resolving disputes concerning its proper interpretation.

The rules discussed here on safeguards against imports being fairly but injuriously traded should be distinguished from the adjustment or transitional measures which may be employed to implement a free trade agreement in the first place. The parties to a free trade arrangement might, for example, agree to permit safeguard protection in specified circumstances for a ten-year period following the agreement's coming into force. Transitional and adjustment measures will be considered in a subsequent part of this research study.

OTHER NON-TARIFF MEASURES

The treaty should also contain effective constraints on a number of rather diverse non-tariff measures which currently restrict or hinder

bilateral trade. The major ones that currently limit Canadian exports to the U.S. market area are:

- discriminatory federal and state government procurement policies;
- federal and state product standards and health regulations that conflict with their Canadian counterparts; and
- U.S. customs classification rules and administrative regulations that impose unreasonable cost burdens on exports from Canada.¹¹⁵

U.S. exports to Canada are adversely affected by similar laws and regulations which are maintained by the federal and provincial governments.¹¹⁶ These barriers will be catalogued in a later section of this study.

The main drafting problem concerning these restrictions on bilateral trade is that they are resistant to control through the enforcement of detailed rules. A good example of this basic regulatory problem arises from recent efforts by the GATT signatories to control preferential treatment for domestic bidders in government procurement. In the tendering process, there are dozens of strategies which governments can employ in order to discriminate in favour of local suppliers. While explicit statutory preferences, such as the "buy American" laws, are relatively easy to monitor and control, attempts to draft codes of specific rules to eliminate all forms of discrimination have not succeeded; this is because they tend to create strong incentives for governments to invent new ways of providing protection that circumvent the rules.¹¹⁷

This basic limitation on the effectiveness of detailed rules is related to a second problem that arises in designing legal arrangements for controlling these non-tariff measures. Some laws and regulations which operate to restrict bilateral trade may be justifiable on legitimate national policy grounds.¹¹⁸ For example, U.S. federal or state consumer-product safety standards covering lawnmowers may specify the installation of certain protective devices which are not required by Canadian law. Would Canadian lawnmower manufacturers be justified in complaining that the U.S. safety standard imposed an unreasonable cost burden on imports from Canada? This is an extreme example, but there have been many recent instances in which it has been difficult to determine whether divergent standards were motivated by legitimate differences in safety policies or consumer-protection policies, or by an implicit desire to discriminate against imported products.

For example, the governors of four midwestern American states have recently imposed a complete ban on imports of Canadian pork products on the ground that Canadian farmers treat their hogs with an antibiotic which may cause cancer in humans. Health experts have advanced conflicting opinions on the risks attributable to this antibiotic, but the consensus view is that the health risk is fairly minimal. No other state and no provincial or federal government has banned the use of this

medicine by pork producers. Moreover, the four midwestern states which have imposed the ban contain large and politically influential agricultural industries that have recently been hard pressed by low-priced imports of Canadian pork.¹¹⁹ Considering the circumstances surrounding the pork quarantine, Canadian producers view these health regulations as a pretext or ruse employed only for the purpose of providing protection to midwestern American farmers.

To sum up, the second basic difficulty encountered in regulating many types of non-tariff measures is that reasonable people will frequently have differences of opinion concerning acceptable justifications for restricting bilateral trade.

While it will be necessary for a free trade agreement to contain detailed codes regulating procurement practices, product standards, customs procedures, etc., recent GATT experience with similar codes of conduct indicates that even the most concrete and specific rules are relatively easy to circumvent. Effective regulation of these barriers to bilateral trade will require the agreement's enforcers to apply general standards or principles prohibiting unreasonable or unjustified protection against imports. In other words, the institutions created to implement the treaty will need to possess broad discretionary powers in order to prevent evasion of the agreement's substantive obligations and in order to elaborate and expand the arrangement's normative content to deal with problems that were not foreseen when the treaty was drafted. Moreover, the difficulties that will be encountered in implementing the treaty will not be confined to mere technical disagreements on law or economic facts; they will also raise difficult questions of political judgment concerning acceptable justifications for trade restrictions. In short, the design of an effective set of institutional arrangements for administering and interpreting the agreement will be the main determinant of the treaty's future success in controlling the non-tariff measures which currently restrict bilateral trade.

ADJUSTMENT ASSISTANCE AND TRANSITIONAL MEASURES

For reasons discussed earlier, it seems certain that the vast majority of Canadian investors and employees are likely to bear relatively larger adjustment burdens than their U.S. counterparts as a consequence of bilateral free trade. In the agreement, it would therefore be desirable to incorporate certain provisions that are designed to mitigate the proportionately greater adjustment costs that Canadians will have to cope with during the transitional phase of bilateral trade liberalization. One solution would be to provide for temporary safeguard measures in order to slow down the rate of industrial dislocation and to smooth out the re-employment of workers and physical capital. For example, the Swedish-

EEC free trade agreement included a system of "trigger points" that could be used to provide temporary relief from import competition during the arrangement's initial stages of implementation.¹²⁰ Generally, the trigger-point mechanism authorizes the signatories to impose temporary safeguard protection if imports flood in at higher than anticipated levels after the creation of the free trade area. This allows those industries that are under the greatest competitive pressure from increased imports to lag behind in meeting the general tariff-cutting schedule established by the treaty or to delay the removal of existing non-tariff barriers.

If the trigger-point scheme, or some similar mechanism, is included in a bilateral arrangement, it will be desirable to include clear rules limiting the scope and duration of its application. Permanent employment or value-added guarantees are inconsistent with Canada's compelling need to remedy the structural weaknesses of its secondary manufacturing industries. Moreover, recent experience with permanent safeguards under the Autopact suggests that guarantees relating to specific employment levels are very difficult to enforce and that, in any event, U.S. negotiators are certain to resist their inclusion in a bilateral agreement.¹²¹ Many of the administrative and political difficulties encountered with the Autopact guarantees (including, for example, the long-standing dispute between the signatories concerning the intended duration of the safeguards) would be likely to surface again if such provisions were incorporated in the treaty.¹²² Therefore the agreement should clearly establish that any authorized delays in the removal of protective measures are to be temporary only, and that all transitional safeguards must contain "sunset" provisions specifying a definite date for their automatic repeal.

Based on experience under the GATT, and with regional preferential trading arrangements involving developed industrial nations such as the Treaty of Rome and the EFTA, adjustment costs resulting from the removal of trade barriers have generally turned out to be less of a problem than most observers anticipated. The empirical evidence, recently reviewed for this Commission by Whalley,¹²³ indicates that adjustment costs have remained low in most instances of postwar regional economic integration, because trade liberalization among developed industrial nations did not lead to the displacement of entire industries and thus to the dislocation of workers and physical capital. Indeed, when the competitive pressures generated by the removal of trade barriers forced the discontinuation of unprofitable lines, most firms simply adjusted by making new products within the same industry. The severity of the adjustment burdens created by Canada-U.S. free trade will therefore depend on the ability of Canadian firms to carve out specialized niches for themselves in an integrated North American market.¹²⁴ Harris's recent study¹²⁵ for the Commission concludes that

adjustment costs would be higher for a Canada-U.S. free trade area than they were for the EEC and the EFTA, because of the greater likelihood that some large Canadian industries would suffer substantial contractions. Harris's study also speculates that approximately 7 to 10 percent of the Canadian workforce would be required to find new jobs in other industries as a consequence of comprehensive bilateral free trade.

Two existing institutional arrangements would help to mitigate the adjustment costs of bilateral trade liberalization. The first is the flexible exchange rate, which should provide some braking mechanism against a rapid influx of imports and a loss of jobs in Canada. U.S. multinationals operating in Canada should also help to ease adjustment problems, because they already own facilities for distributing any newly specialized output of their Canadian plants in the U.S. market. Despite these equilibrating forces, many Canadian workers and investors, particularly those in the most import-sensitive manufacturing industries, will suffer heavy losses on their human and physical capital. It is certain that an extensive program of adjustment assistance will be needed as an integral part of any comprehensive free trade arrangement, both to assist workers and capital in exiting from declining industries and to facilitate their absorption into expanding sectors.

Since workers, managers, and investors will begin planning their strategies for adjustment even before a final bilateral agreement is concluded, it is important that the treaty should contain a carefully designed framework which sets out the appropriate role for national and subnational governments in facilitating these industrial transitions. Publicly financed adjustment assistance might be provided in a variety of forms: government-backed loans, special research and development grants, or accelerated depreciation for Canadian firms that rationalize their operations in order to expand into the U.S. market. Programs should also be designed to support displaced workers and to speed up their retraining or re-employment.¹²⁶ Public support for these programs could be financed through a temporary sales tax. A transitional consumption tax would ensure that at least some of the adjustment costs borne by workers and investors would be defrayed by the Canadian consumers who stand to benefit from cheaper U.S. imports. Finally, any subsidies to facilitate adjustment would have to be expressly authorized by the free trade agreement in order to shield them from U.S. countervailing duty proceedings.

Implementation and Dispute Settlement

A legally and politically effective free trade agreement will require appropriately designed governing institutions and implementation procedures. Specific arrangements for implementation are needed to ensure

that the legislation and regulations of both nations will be brought into full compliance with the treaty's obligations. Moreover, Canada's need for secure market access militates in favour of a strong intergovernmental organization to administer the free trade arrangement, together with a legally binding process for settling disputes about the proper interpretation of the treaty's provisions. Since there is certain to be opposition from those groups of workers and investors who must bear the costs of adjusting to freer trade, it is essential that a Canada-U.S. arrangement should be implemented through legal procedures that protect its political durability and reduce the likelihood of subsequent national laws and regulations which would undermine its effectiveness.

IMPLEMENTATION PROCEDURES

Under U.S. constitutional law, a bilateral free trade agreement could be structured as a formal treaty, or it could be put into effect through the passage of conforming federal and state legislation.¹²⁷ Implementation by state governments will be necessary to give effect to the treaty's provisions on government procurement policies, on barriers to trade in services, and on discriminatory product standards and other non-tariff measures imposed by state statutes and regulations.¹²⁸ The primary advantage of the formal treaty procedure is that treaty provisions would take precedence over any state statutes or pre-existing federal statutes that legislate trade barriers in violation of the treaty's substantive obligations. Implementing a bilateral arrangement through a formal treaty would therefore provide Canadian exporters with a strong legal guarantee of future market access. On the other hand, the major disadvantage of this strategy is that a formal treaty must be ratified by a two-thirds majority of the U.S. Senate. Since the Senate's representational structure provides each state with equal voting power, interest groups from the smaller, less populous states can often exert more influence in the Senate than they can in the House of Representatives. Bilateral free trade will impact most heavily on the less populous border states of New England and the Pacific Northwest; it seems likely that producer groups from these states will attempt to organize a coalition aimed at blocking a bilateral agreement in the Senate, where they have the most political power. Indeed, past experience with the Senate ratification procedure indicates that it would be very difficult to secure a two-thirds margin of Senate approval for a comprehensive and detailed free trade agreement, which is the only type of arrangement that would satisfy Canada's negotiating objectives.¹²⁹ In other words, the main downside risk in attempting to obtain Senate ratification is that the process might well trigger a large number of amendments designed to undermine the treaty's effectiveness.

The alternative option is to implement the free trade agreement by securing the enactment of U.S. federal and state legislation incorporating its substantive obligations. This strategy provides a weaker constraint on future non-compliance by state governments, since the implementing legislation could be amended by subsequent legislatures that were less favourably inclined toward bilateral free trade. The main advantage of the statutory approach is that it would permit implementation through simple majority-voting procedures, both in Washington and in the state capitols.

Moreover, the risk of a comprehensive free trade agreement being watered down or otherwise renegotiated at the legislative approval stage could be reduced through preparatory political work by the U.S. president. In past multilateral trade negotiations, U.S. presidents have sought advance negotiating authority from Congress, and executive branch officials have engaged in extensive consultations with both federal and state legislators. During the Tokyo Round, the U.S. Congress agreed to implement the trade agreements concluded during the negotiations by enacting conforming legislation through a "fast track" procedure.¹³⁰ This procedure required the Congress to pass implementing legislation within 90 days of the president's formal declaration that an acceptable agreement had been concluded. More important, the Tokyo Round procedure banned the introduction of amendments to the implementing legislation during its passage through both houses of Congress. If the Canadian and U.S. governments succeed in negotiating a mutually acceptable arrangement, the "fast track" procedure significantly reduces the risk that the package of compromises sustaining the treaty will be broken down by legislative wrangling at the implementation stage.

Canada's parliamentary form of representative democracy is designed to ensure the effective centralization of executive and legislative powers to implement international trade agreements at both the federal and the provincial level of government. The cabinet of a majority government is virtually guaranteed success in securing legislative implementation of any international agreement it decides to conclude, except in the unlikely event that an election defeat occurs before the legislation can be enacted.¹³¹ For Canada, the major challenge in securing effective implementation of a bilateral agreement will be to obtain the cooperation of provincial governments. Since Canadian provincial governments possess more extensive constitutional authority to tax, subsidize, and regulate economic activities than American state governments do, the problem of securing consensus between the two coordinate levels of government will be more difficult in Canada than in the United States. A subsequent part of this research study analyzes the legal and political problems that are likely to arise from an attempt to achieve federal-provincial consensus on bilateral free trade.

INSTITUTIONAL STRUCTURE

The design of appropriate institutional arrangements for a Canada-U.S. free trade agreement is, to a large extent, predetermined by choices made on other key issues, such as the scope of the barriers and commodities to be covered, and the substantive content of the treaty's obligations. If the treaty aims at the comprehensive removal of existing impediments to bilateral trade, the governing institutions will be confronted with a large volume of technically complex problems that will require executive and administrative decisions, the services of an expert staff, and appropriate mechanisms for handling complaints and disputes concerning the agreement. If the treaty contains both detailed rules and general principles designed to limit non-tariff measures, the institutions responsible for the agreement's application and enforcement will need to combine the capacity for making sound judgments on controversial political issues with the ability to resolve difficult legal, economic, and factual questions.

In addition to these functional considerations, other fundamental characteristics of the Canada-U.S. relationship should be taken into account when designing the institutional structure of a bilateral free trade area. Across-the-board free trade will increase Canada's economic dependence on a nation ten times its size, arguably the world's strongest economic and military power. The treaty's decision-making procedures should be designed to reduce this marked disparity in bargaining power and to ensure that the agreement is not administered or applied with a bias toward the interests of the stronger party.

A second feature of the bilateral relationship is the immensity of its economic scope, encompassing the world's largest two-way network of trade and investment activities. In fact, in 1983 and 1984 two-way merchandise trade surpassed total trade between the United States and the ten members of the EEC.¹³² A comprehensive free trade agreement is certain to generate such a large volume of administrative and executive decisions that mechanisms to ensure consistency and predictability will be of the upmost importance. Ad hoc solutions negotiated on a case-by-case basis will sometimes be unavoidable, but there will be strong budgetary and political pressures for routinized decision-making processes that provide speedy, predictable, and final resolutions of disputes.¹³³ Finally, since both nations hold large stakes in maintaining the stability of their economic relationship, the bilateral treaty's governing institutions should be designed to limit the potential for the escalation of conflicts arising under the treaty, especially those serious enough to threaten the agreement's survival.¹³⁴

In light of these functional criteria and background considerations, the task of designing appropriate institutions for the bilateral arrangement can be encapsulated in two interrelated questions:

- Will the key decisions taken under the proposed free-trade agreement be made by the two national executives (which is the current method for managing bilateral economic relations), or will they be taken by a standing body of representatives who have long, fixed terms of office and some substantial degree of independence from their national governments?
- Would the decisions of any body created to resolve disputes arising under the treaty have legally binding force, or would they be merely advisory or recommendatory?

These questions are closely related, because choices on the structure and composition of a decision-making body will be strongly influenced by the legal and practical consequences of its future decisions. The remainder of this part of the research study attempts to answer these questions in the order set out above.

It will be essential to have some form of standing organization that is authorized to carry out lower-level administrative functions, to provide technical advice and specialized research services, and to assist in the resolution of disputes arising under the treaty.¹³⁵ But, as Stone and Osmond's study for the Commission argues, there is no persuasive case in favour of creating a formal transnational body which has decision-making powers that are insulated from the direct control of the national governments.¹³⁶ The constitutional ethic of democratic accountability, which is shared by both nations, militates in favour of involving executive officials at the highest level of government in the resolution of significant questions concerning the treaty's application and evolution. All major decisions involving the initial implementation and on-going administration of the agreement should be made by a committee of national officials serving at the ministerial level. This body might be composed, for example, of the ministers of external affairs and international trade, and the Department of Regional and Industrial Expansion (DRIE). On the U.S. side, it might include the special trade representative, the secretary of state, and the secretary of commerce. Since each nation would have equal voting representation in the committee, each would retain a *de facto* veto power over all significant decisions taken under the agreement. No existing bilateral free trade arrangement is administered by a transnational body that is legally autonomous from its member nations.¹³⁷ Even the EEC, a common market with the avowed aim of political integration, is governed by a transnational body, the EEC council, whose legal and political independence is significantly constrained by the member governments. The EEC council takes decisions on most important issues only upon a unanimous vote of its national representatives.¹³⁸ Since the administration of free trade agreements involves difficult questions of political judgment, it is desirable for politically accountable officials to accept ultimate responsibility for the implementation and enforcement of these arrangements.

The size and composition of the staff required to support a ministerial committee structure would depend on the choices taken regarding several of the substantive drafting options discussed earlier. For example, if the enforcement of anti-dumping, countervailing duties, and safeguard measures is to become a responsibility of the committee of ministers, then it would be desirable to create a standing tribunal to receive complaints and adjudicate on questions of law and fact. The committee's role would be limited to appellate review of the tribunal's final judgments.

Since any workable agreement will contain rules and standards framed in broad and uncertain language, conflicts will inevitably arise over the meaning of the agreement's substantive obligations. While the committee should take ultimate responsibility for resolving disputes, some form of fact-finding and advisory mechanism would be necessary in order to investigate complaints and to provide a focussed analysis of the key legal and economic issues. One option would be the creation of a consultative council, composed either of private experts (e.g., retired public servants, business executives, labour leaders, academics, etc.) or of public servants, or some mix of both, to engage in fact-finding and conciliation in aid of resolving disputes.¹³⁹ Panels of council members could be assigned to investigate specific complaints of non-compliance made by Canada or the United States, and to find the facts and attempt to mediate a negotiated settlement among the government departments involved. If the disputants failed to agree on a settlement, the panel would be required to make written recommendations to the committee of ministers concerning the appropriate resolution of the dispute. Moreover, panels could also be assigned to assist the ministers and their departmental staff with drafting and bargaining on proposed amendments to the free trade agreement, either extending its coverage or changing its substantive rules.

For the most part, Canada and the United States have relied on ad hoc bilateral negotiations to resolve most of the disputes that have arisen in their long-standing economic relationship. However, Stone's careful analysis of past bilateral conflicts indicates that negotiations are only successful in resolving disputes when the interests and aims of the two nations have been reasonably congruent or when the stakes involved have been relatively unimportant to one of the governments.¹⁴⁰ In several notable disputes where the stakes were high for both nations, negotiations have dragged on, leaving tensions unresolved and creating substantial uncertainty among actors in the private sector.¹⁴¹ Such interminable conflicts have arisen under the Canada-U.S. Defense Production Sharing Arrangements and the Autopact. Neither arrangement has any formal structure for the settlement of disputes; both rely on bilateral negotiation and diplomacy to resolve interpretive problems. The serious confrontations and threats of abrogation that have plagued the Autopact could have been avoided by the inclusion in the treaty of an appropriate procedure for resolving negotiating deadlocks.¹⁴²

Negotiation alone cannot provide an adequate system of dispute settlement for a Canada–U.S. free trade arrangement. The option of binding arbitration as a last resort, in cases where the normal fact-finding and conciliation processes fail to resolve a serious dispute, would strengthen the credibility and predictability of North American free trade. Moreover, Canadian interests and economic objectives will be better served if future interpretive disputes are resolved through binding arbitration by a standing tribunal that has strong bipartisan representation.¹⁴³ From Canada's standpoint, binding arbitration would be preferable to bargaining with a stronger adversary who has comparatively less to lose from the weakening or abrogation of the agreement. A specific treaty obligation to submit future disputes concerning the agreement's interpretation to binding arbitration, at the instance of either party, would send a strong symbolic message to prospective investors, emphasizing the security of Canada's market access guarantee. It would also safeguard Canadian political autonomy by providing a deterrent to unfair or insensitive demands that were backed up by threats of non-compliance with the agreement.

An effective arbitral tribunal would, of course, require the appointment of neutral or bipartisan members in order to ensure that a body comprising equal numbers of national representatives would not be paralysed by deadlocks. It could be established as a five-member standing body, consisting of two Canadians, two Americans, and one neutral member. Decisions would be taken on the basis of a simple majority vote, and members would serve for five-year renewable terms. The selection of the neutral voting member would be an issue of the utmost importance; the person selected would need to possess diplomatic skills, good political judgment, and a detailed knowledge of the bilateral economic relationship.¹⁴⁴

Finally, the treaty should limit the jurisdiction of the tribunal to disputes arising from conflicting interpretations of the agreement; the tribunal should not be allowed to rule on issues not covered by the treaty, unless both nations consented. Moreover, it is important to recognize that the arbitral mechanism proposed here is intended as a last-resort solution to serious stalemates. The tribunal's main purpose would be to provide a strong incentive for the parties to achieve negotiated solutions.

The Regulation of Foreign Direct Investment and Transfers of Technology

Introduction

Foreign direct investment has played an influential role in the development of Canada's diversified industrial economy; and in the decades ahead, inward flows of equity capital, and the new ideas and techniques

that often accompany it, hold out the potential for significant contributions to national economic growth. On the other hand, foreign direct investment leads to a situation in which firms or individuals domiciled abroad have control of economic activity conducted in Canada. The multinational character of most foreign-controlled firms makes such enterprises more susceptible than domestically based firms to the tax and regulatory policies of foreign governments; when a foreign government's policies conflict with Canadian interests, firms operating in Canada whose assets are concentrated in that jurisdiction will be less amenable to regulatory control by Canadian national and provincial governments.

During the 1970s, many Canadians expressed concern over the comparatively high levels of foreign ownership and control in the secondary manufacturing and natural resource sectors.¹⁴⁵ The federal and provincial governments responded with regulations and other policies that were designed either to limit the scope of foreign control or to reduce its adverse consequences. This section of the study surveys current laws and regulations affecting foreign-controlled enterprises in Canada, including major changes in the federal regulatory scheme that were enacted in March 1985. The consequences of these various types of legal control are evaluated in terms of their impact on Canadian economic development and in terms of the parliamentary political process. The first part of this section presents some concrete proposals for improving existing regulatory mechanisms, including suggestions for procedural changes that would upgrade the political accountability of the regulators of foreign direct investment.

Canada's economic prospects will also depend on the nation's ability to keep abreast of contemporary technological developments. Canada is a technology-importing nation; the amount of technological development carried on in Canada is relatively low compared with the levels of such activity prevailing in most developed industrial nations (e.g., 95 percent of all patents are granted to individuals or corporations domiciled outside Canada).¹⁴⁶ Inward flows of technology occur in two basic ways: technology transfers to Canadian affiliates of multinational enterprises; and transfers by licence, which involve an arm's-length transaction between foreign patent or trademark holders and Canadian purchasers of the technology.

The second part of this section examines the impact of current laws and regulations on the internal transfer of technology within foreign-controlled multinationals, since this is an integral aspect of the legal control of foreign direct investment; the third and fourth parts examine existing laws and policies governing the rights and obligations of foreign owners and foreign licensors of commercially valuable technologies.

Since Canada imports such a large proportion of the technologies it utilizes, a major issue is whether a diminution in the legal rights of patent

and trademark licensors would allow Canadians to derive greater benefits from purchases of foreign technology. For example, Canadian competition law permits patent licensors to impose a number of contractual restrictions on the use of licensed technology (e.g., prohibitions on the export of the patented product, or "tied" purchasing clauses which oblige the licensee to purchase materials or components from a designated supplier). Another controversial issue concerns the recent application of compulsory licensing regulations in the Canadian pharmaceuticals industry and the proposals of the Science Council of Canada for the extension of similar regulations to most industries in the secondary sector. Finally, Canada's dependence on imported technology implies that there is a strong national interest in preventing (or minimizing the impact of) foreign government regulations or policies which restrict the export of new technologies. The third and fourth parts of this section analyze these three key issues and concludes with a brief discussion of recent proposals for the multilateral regulation of technology transfers, such as the UNCTAD code of conduct, and the likely impact of such international legal developments on Canada's economic future.

Rationales for Regulation of Foreign Direct Investment

A brief review of some basic facts concerning foreign direct investment in Canada is necessary in order to contextualize and clarify the arguments both for and against government regulation of foreign-controlled firms. The empirical studies distinguish between the level, or "stock," of foreign capital holdings in Canada and the movements, or "flows," of foreign funds into and out of the country. Several general conclusions concerning recent patterns and future trends in stocks and flows can be drawn from the empirical evidence. First, the statistics on annual flows indicate that the inward movement of foreign direct investment has decreased from the peaks reached in the early 1970s, when the demand for government regulation was strongest. In fact, Canada's share of global inward investment flows has fallen from 6 to 3 percent since the 1960s.¹⁴⁷

Several factors have contributed to this decline in Canada's relative position as a host for foreign investors. There has been rapid economic growth in the developing countries, at least until the late 1970s, and these nations have attracted a much greater proportion of transnational investment than they did in the immediate postwar era.¹⁴⁸ In addition, slower economic growth in Canada since the mid-1970s, and the initiation of nationalist regulations and subsidies such as the *Foreign Investment Review Act* and the National Energy Program, have probably deterred prospective investors. In a more competitive global capital market, in which a number of host countries frequently engage in bidding contests for new investments, the deterrent effect of nationalist policies and their

consequent costs in terms of economic opportunities foregone are likely to be greater in future decades.

An empirical analysis limited to inward capital flows ignores the quantitatively significant role of regained earnings as a source of new foreign direct investment. Reinvestment of earnings by foreign-controlled firms has a cumulative effect on the stock of foreign holdings, and this is not reflected in balance-of-payments statistics. While flows of direct investment into Canada may have slowed and even turned negative in recent years, the annual accumulation of earnings caused the stock of foreign investment to continue to rise during the late 1970s and early 1980s.¹⁴⁹

Foreign ownership of capital in many Canadian industries remains very high by international standards, even though there were significant declines in some sectors during the 1970s. In 1983, companies whose equity was controlled abroad accounted for approximately 50 percent of the capital employed in Canadian manufacturing industries; they accounted for 44 percent in petroleum and natural gas, 46 percent in mining and smelting, and 6 percent in all other industries, excluding finance and agriculture, in which foreign ownership is virtually nonexistent.¹⁵⁰ Most of these stocks of foreign capital are owned by U.S. investors, who currently hold approximately 80 percent of all foreign direct investment in Canada.¹⁵¹

No other comparable developed industrial economy has more than 40 percent of its manufacturing capital owned by companies controlled by foreign residents; among these nations, those with the highest stocks of foreign holdings, such as Australia, Belgium, and Ireland, have much smaller and less diversified economies than Canada. Italy, France, West Germany, and the United Kingdom have between 20 and 30 percent of their total manufacturing capital held by foreign-controlled enterprises, while Sweden and Norway have only around 10 percent.¹⁵² In short, Canada's stock of foreign equity investment is the highest among comparable developed nations, and foreign-controlled enterprises are certain to play a significant role in shaping Canada's economic future.

Finally, outward flows of Canadian capital have increased significantly in recent years, and there has been a sharp increase in the stock of Canadian-held foreign direct investment. In fact, while U.S. investment flows to Canada have been declining, Canadian investment in the United States has grown at an unprecedented rate.¹⁵³ Although Canada is likely to remain a net importer of capital for the foreseeable future, these large outward flows indicate that our policy stance on foreign investment must take into account the potential benefit of securing equitable reciprocal treatment for Canadians who seek to invest abroad.

While the economic benefits of foreign direct investment are difficult to measure accurately, the vast majority of economic analysts believe that the welfare gains from inward capital flows are substantial and are

likely to become increasingly important as a catalyst of future growth.¹⁵⁴ In addition to the obvious advantage of access to foreign capital at highly competitive world market rates as a supplement to domestic savings, Canada gains increased public revenues from exercising its right to tax income attributable to foreign-controlled enterprises. Whalley has recently estimated that the annual welfare gain to Canada in the form of tax revenue derived from foreign holdings is between 1.5 and 2.5 percent of Gross National Product.¹⁵⁵ Moreover, foreign investment is Canada's primary source of valuable technology and entrepreneurial "know-how."

Since innovative ideas and techniques will be the key to Canada's future economic success, regulations and other policies aimed at foreign-controlled enterprises should be designed to avoid unnecessary restrictions on the inward flow of new technologies. Equity ownership is often highly valued by foreign innovators, because it permits them to retain more control over the future commercial exploitation of their ideas. If regulatory restrictions on investment have the practical result of requiring foreign patent holders to license the use of their ideas to domestic firms which they do not control, either the licence fees charged will generally be higher than if control was retained, or foreign innovators will take their ideas to other countries where they can exploit them on more advantageous terms. Recent work by McFetridge and others shows that patent licence transactions between unrelated companies (that is, arm's-length licence agreements) usually involve relatively older technologies, while newer technologies tend to be transferred internally within multinational firms.¹⁵⁶ Moreover, these comparatively older technologies transferred by licence tend to involve incremental innovations, while the technologies exchanged among the subsidiaries and affiliates of multinationals usually involve more radical innovations in product design and production technique.¹⁵⁷ In order to sustain world-class competitors in the secondary sector, Canada must ensure that it obtains the newest technologies as quickly as its major rivals, most of whom possess domestic industries that invest much more in research and development than their Canadian counterparts do. The recent decline in inward flows of foreign direct investment is therefore likely to have an adverse impact on the technological progressiveness of Canadian industry, and the opportunity costs of constrained access to new technologies must be taken into account in assessing the pros and cons of existing regulations aimed at foreign-controlled firms.

The regulation of foreign-controlled firms in Canada has been justified primarily in terms of increasing the dynamism and technical efficiency of Canadian industry. Canadian proponents of regulation aimed at controlling foreign direct investment have argued that foreign parent companies tend to operate their Canadian subsidiaries as "branch plants,"

designed exclusively to serve the domestic market.¹⁵⁸ They claim that the resulting "truncated" industrial structure has the effect of blocking the development of a more dynamic export-oriented Canadian economy. In support of this argument, empirical evidence has been collected and interpreted to show that Canadian subsidiaries of foreign parent firms have tended to import more, to export less, and to carry on fewer managerial and scientific activities in Canada than comparable businesses controlled by Canadian residents.¹⁵⁹

On the other hand, most academic economists who have analyzed the causal link between foreign control and deficient industrial performance in Canada have concluded that the evidence in support of such a connection is weak. For example, while domestically controlled firms in the manufacturing sector tend to be more specialized and to spend more on research and development than their foreign-controlled counterparts, the latter tend to have lower costs and more export sales.¹⁶⁰ There is some persuasive evidence that foreign-controlled firms tend to import more goods and services than domestic firms, but the correct explanation for this observed pattern, and its probable economic impact, is unclear.¹⁶¹ The higher propensity of foreign-owned firms to import could be a result of the unavailability of suitable inputs or components from Canadian sources of supply. If Canadian suppliers do exist, their products may not be competitive with imports in terms of price or quality.

The weakness of the empirical case for systematic performance differences between foreign-controlled and Canadian firms indicates that there may be more robust explanations for Canada's truncated industrial structure than those emphasizing the causal role of foreign equity ownership. A history of comparatively high tariff protection for manufacturing (which has been lowered significantly only in the past two decades), a relatively small internal market, and the tariff and non-tariff barriers maintained by Canada's major trading partners have all made significant contributions to our weak industrial structure.¹⁶² Moreover, the evidence shows that foreign and domestic investors have responded in similar ways to the incentives that were generated by these past government policies and geographical constraints.¹⁶³

Another argument for regulating foreign-owned firms concentrates on the special difficulties which national governments frequently encounter in attempting to influence the managerial processes of multinational enterprises. Companies that conduct the preponderance of their commercial activities outside Canada will tend to be more responsive to the policies and directives of foreign governments than firms based in Canada will be. The business decisions of American-owned multinationals operating in Canada are shaped by tax and regulatory policies made in the United States, and serious conflicts have arisen during the past two decades when foreign multinationals have been forced to

choose between the competing policy directives of U.S. and Canadian governments. Recent disputes have involved export restrictions imposed by the United States for national security reasons, the attempted extra-territorial application of U.S. anti-trust and other regulatory laws, and U.S. tax laws that encourage multinationals to repatriate their foreign-source income and to expand their production in the United States, rather than to increase the size of their foreign operations.¹⁶⁴ The relative frequency of these bilateral conflicts over the past two decades indicates a need for a negotiated legal framework to clarify the rights and duties of both host and home governments in regard to the regulation of multinational firms.

A third argument for government intervention is that Canadian firms that are controlled from abroad are often prevented from exporting, or from conducting innovative research programs — even when it would be cost efficient to carry on such activities in Canada. The reasons frequently cited for these alleged economically perverse restrictions are the national chauvinism of foreign managers and the short-sightedness and inertia that often occur in large and complex corporate bureaucracies.¹⁶⁵ For example, there is some evidence that foreign-controlled firms in the manufacturing and natural resource industries tend to favour established suppliers located in their home countries over Canadian suppliers that offer goods of comparable quality at competitive prices.¹⁶⁶ Similarly, it has been asserted that the managers of multinational parent companies have resisted proposals for providing world-product mandates to Canadian subsidiaries because of their desire to retain control over all aspects of their affiliates' operations.¹⁶⁷

Authoritative evidence to support these claims of prejudice and discrimination by foreign owners and managers is scarce, but this could be because it is difficult to obtain clear proof concerning the true motives of foreign management. Foreign managers are likely to choose input suppliers and locations for new production facilities on the basis of a diverse range of subjective considerations and forecasts concerning future costs and revenues. When U.S.-based parent companies grant world-product mandates to U.S. affiliates and deny them to Canadian subsidiaries, parent management will encounter little difficulty in formulating plausible ex post justifications focussing on purely economic or commercial considerations, even if the true motives underlying the decisions involve U.S. government policy directives or internal corporate politics.¹⁶⁸

Any effective scheme for regulating the activities of foreign-controlled firms must therefore incorporate some mechanism for resolving these contentious questions on an objective basis. Since the foreign parent company has a comparative monopoly of technical information concerning the commercial factors which have influenced its decisions, procedures for encouraging disclosure of such information should be the cornerstone of future regulatory reforms.

Canadian Laws and Regulations Governing Foreign Investors

Most legal scholars distinguish between two different types of regulation currently employed to control foreign direct investment in Canada. First, certain key sectors of the Canadian economy are either completely closed to foreign-controlled firms or, in sectors where such enterprises are allowed to enter, they are required to do business on less advantageous terms than those afforded to Canadian-controlled firms. Virtually all nations maintain a range of key sector controls similar to those deployed by the federal and provincial governments.¹⁶⁹ The second type of existing regulation is more uniquely Canadian, since it is found in relatively few other developed industrial nations.¹⁷⁰ This is the advance screening system, originally incorporated in the *Foreign Investment Review Act*¹⁷¹ (recently renamed the *Investment Canada Act*),¹⁷² which requires that foreign-controlled firms seeking to take over Canadian-owned firms must obtain prior approval from the federal cabinet. The current scheme was recently reformed to exclude prior approval review for foreign investors seeking to establish new businesses in Canada. A brief survey of the advantages and disadvantages of these two types of regulatory instrument will help to provide an analytic framework for considering the appropriate design of future laws and policies aimed at foreign-owned firms.

KEY SECTOR REGULATIONS

A rather large number of federal and provincial statutes designate key industries or sectors which are legally reserved for enterprises controlled by Canadian citizens or residents. During the 1960s and early 1970s, Canadian governments enacted a series of amendments to existing corporate and regulatory laws designed to exclude foreign-controlled firms from the banking,¹⁷³ insurance,¹⁷⁴ broadcasting,¹⁷⁵ and investment brokerage businesses.¹⁷⁶ Moreover, many types of natural resources can be harvested or exploited only by Canadian-controlled firms. For example, foreign-owned firms are not eligible to receive commercial fishing licences or leases, or licences to engage in certain types of mining activity.¹⁷⁷ One argument often raised to justify these restrictions in the natural resource industries is the need to ensure that Canadians obtain the maximum benefit from scarce resources in which all citizens share ownership rights.¹⁷⁸ This is a relatively weak argument, since alternative tax and regulatory instruments could ensure maximum benefits without excluding foreign capital and technology.

A second justification for preventing entry by foreign enterprises focusses on the difficulties of ensuring that foreign-based firms comply with the detailed regulations that exist in many Canadian industries. For

example, federal and provincial statutes banning foreign-controlled firms from the transportation, insurance, trust, and consumer-lending industries have been justified on the grounds that it might be difficult to enforce consumer protection regulations against foreign multinationals.¹⁷⁹ The national security argument for excluding foreign-based firms from the transportation, communications, and strategic materials industries is a special case of this general argument about the difficulties of regulating foreign-controlled companies. While these arguments have some plausibility, it is not difficult to think of alternative legal instruments, such as special bonding requirements or bilateral enforcement agreements, which would provide reasonable guarantees of compliance by foreign-owned firms.

Key sector regulations also require foreign-controlled firms operating in certain industries to compete with domestic firms under special restrictions or conditions. For example, federal banking law limits the size of the share of the domestic market which foreign-owned banks are permitted to hold.¹⁸⁰ Another example is the legislation enacted as part of the National Energy Program of 1980. This legislation amended existing federal energy and tax laws to give Canadian-controlled energy companies more favourable tax and regulatory treatment than that accorded to their foreign-owned rivals.¹⁸¹ Still another example can be found in the discriminatory licensing policies of provincial regulators in the motor transport industries; these policies effectively limit the competition between foreign-owned and domestically based carriers.¹⁸² Discriminatory treatment of foreign firms in the banking, transportation, and petroleum industries has been justified on the grounds that special or exceptional national interests require the preservation of a substantial proportion of Canadian-controlled firms in such types of activity.¹⁸³ The special national interests cited are national security, enhanced regulatory leverage, and security of supply.

Proponents of discrimination against foreign-controlled firms should be required to demonstrate that such handicaps as tax disadvantages and limitations in the share of the market are the most effective and least costly legal instruments for achieving the desired policy outcomes. In most industries where these discriminatory measures have been employed, explicit subsidies for domestically controlled firms (a form of affirmative discrimination) would seem to be a preferable substitute, on the grounds of both economic efficiency and political accountability.

The most convincing argument for maintaining closed sector controls is that all our major trading partners maintain laws and regulations which restrict Canadian firms from participating in most of the industries discussed above.¹⁸⁴ Unilateral liberalization of these restrictions by Canadian governments would be unwise on strategic grounds, considering that anticipated bilateral and multilateral negotiations on freeing

barriers to trade in services are certain to focus on the removal of closed sector controls. Any future relaxation of Canadian controls should be undertaken in exchange for reciprocal concessions from our major trading partners.

To sum up, the decision to close a sector or a type of activity to foreign investors (or to buy out or eliminate controlling foreign interests) is the strongest form of regulatory action that a country can take, because it depends on the assumption that the potential costs of foreign control outweigh the benefits likely to be gained from accepting foreign participation. Yet a review of the evidence on the costs and benefits of foreign direct investment indicates that in most instances the benefits are substantial and the costs are negligible or uncertain. A strict preventive approach to foreign equity investment may also provide economically wasteful protection to domestically owned firms, undermining their incentive to improve their competitive performance. Because there will usually be superior legal instruments to carry out the policy objectives which ostensibly justify the use of closed sector controls, these measures should be reserved for genuinely exceptional cases, in which national security or cultural preservation justify the exclusion of foreign-owned firms.

PRIOR APPROVAL REGULATION

The second major component of existing Canadian regulation aimed at foreign-controlled firms is the prior screening procedure established by the *Foreign Investment Review Act*, which has recently been revised substantially and renamed the *Investment Canada Act*. Basically, under this scheme, "major" foreign investments (that is, those involving a controlling interest) are reviewed by an expert staff established exclusively for this role. The staff performs a detailed cost-benefit analysis of the proposed investment to determine whether the foreign-controlled enterprise would confer benefits on Canada in light of five rather vague statutory criteria which identify such factors as job creation, technological innovation, and export potential.¹⁸⁵

In many instances, the staff negotiates with foreign investors concerning their business plans and attempts to secure performance commitments designed to increase the likelihood that the firm's proposed activities will confer economic benefits on Canadians. These written undertakings describe the proposed business activities of foreign investors, and they frequently include specific promises concerning planned purchases of goods and services from domestic suppliers, anticipated levels of export sales, or even plans to expand Canadian equity participation in the enterprise.¹⁸⁶ While the agency staff does not exercise any official decision-making power, its recommendations have been influential in

shaping the cabinet's final decision to grant or deny approval to foreign investors.

The cabinet's central role in approving foreign investment applications ensures that regulatory policies toward foreign investors remain secret and insulated from public scrutiny. The cabinet does not provide written reasons for its decisions on proposed foreign investments, and there is no meaningful right to judicial review in order to ensure that the decisional standards prescribed by Parliament are respected by the executive.¹⁸⁷ This lack of clarity is partly because of the ambiguous or open-textured nature of the statutory language, which refers to such factors as the proposed investment's "effect on the level and nature of economic activity in Canada" and its "compatibility with national industrial and economic policies."¹⁸⁸ However, equally ambiguous decisional standards can be found in other federal regulatory legislation dealing with domestic market entry controls; and quasi-judicial tribunals, boards, and commissions have been charged with the task of elaborating the principles and rules which impart concrete and predictable meanings to these vague directives.¹⁸⁹

The secrecy of the existing process is usually defended on the grounds that, when negotiating with foreign multinationals, the agency staff will be in a stronger position if the multinationals do not know what conditions were imposed on past investors or what weight was given to specific types of economic benefit. But secrecy entails offsetting costs that probably outweigh its strategic bargaining advantages.¹⁹⁰ Foreign investors' lack of objective information on Canadian policies has contributed to widespread misunderstanding, both abroad and at home, concerning the government's regulatory aims; in particular, it has caused many observers to exaggerate the actual coercive or restrictive effect of prior approval regulation.¹⁹¹ Most foreign investors know that more than 90 percent of all past applications have succeeded, but they know very little about the characteristics of the rejected proposals. This uncertainty concerning government policy deters desirable foreign firms from applying for approval, since applications involve non-trivial sunk costs. It is impossible to estimate the cost of these foregone development opportunities, but they could be substantial.¹⁹² In addition, foreign misunderstanding of Canadian regulatory policies may lead to retaliatory restrictions on Canadians seeking to make investments abroad.

The Mulroney government has recently enacted several significant reforms to the foreign investment review process. First, foreign investments aimed at creating new businesses in Canada will no longer be subject to prior approval review, except in those few cases where their operations might adversely affect Canadian cultural activities.¹⁹³ Secondly, foreign takeovers of existing Canadian firms will continue to be reviewed, but the applicants will no longer be required to prove that their

proposed investment will result in "significant benefits" to Canada. Under the new legislation, proof of "net benefit" to Canadian economic development will be sufficient to secure approval for takeovers.¹⁹⁴ Finally, the new act limits automatic review to takeovers of firms with assets in excess of \$5 million.¹⁹⁵ Under the previous legislative scheme, all foreign direct investments involving businesses with assets of \$250,000 or more were subject to regulatory scrutiny. In short, the overall thrust of the recent reforms is to scale down the scope of prior approval regulation to a significant extent, as well as lessening the obligation of foreign investors to demonstrate that their proposed activities will be beneficial to Canadians.

In light of the intense global competition to acquire new investment and technology, and Canada's comparatively weak performance in attracting new foreign investors during the past decade, the Mulroney government's recent reforms are a step in the right direction. The prior approval approach to regulating foreign-controlled enterprises is subject to the inherent limitations of incomplete information and pervasive uncertainty concerning future market conditions. Because review necessarily occurs prior to the actual commencement of operations, its accuracy and effectiveness depend on forecasts and speculative assumptions about future market developments. Foreign investors usually possess comparatively more information than the agency staff concerning their project's likely consequences, and they therefore have a substantial strategic advantage when bargaining with the regulators. Moreover, undertakings or promises concerning their firm's future behaviour are invariably conditioned on the accuracy of these economic forecasts. There is a strong incentive for foreign investors to offer generous undertakings if the agency staff can be persuaded to accept highly optimistic forecasts of the venture's profitability.¹⁹⁶

Thus, undertakings concerning post-entry behaviour do not significantly enhance the government's regulatory leverage over foreign-owned firms, because the pervasive economic uncertainties inherent in the bargaining process undermine the agency's ability to insist on strict compliance with specific promises made at the time the investment was approved. To date, no foreign investor has ever been sued or prosecuted for failing to comply with undertakings.¹⁹⁷

Given the limited benefits that can be anticipated from prior approval regulation, and the large expense of the skilled staff necessary to sustain a meaningful review process, it makes sense to concentrate on foreign takeovers of fairly large domestically controlled enterprises. Since the enterprise under review will be an existing firm, its track record should help to reduce some of the uncertainty about its future performance under foreign ownership. Moreover, the exemption for new investments can be supported on the grounds that their anti-competitive impact on

the Canadian industry is likely to be much smaller, since, unlike takeovers, they increase the number of independent rivals competing in the domestic market.

Proposals for Reforming Regulations Governing Foreign Investors

If prior approval regulation is to be retained in spite of its very limited potential, it should not be focussed on the magnitude of expected benefits from a foreign takeover; rather, it should be focussed on the possible risks or disadvantages of foreign control. One key determinant of industrial performance, which has too often been neglected in the investment review process, is the vitality or intensity of competitive rivalry among both foreign and domestic firms in the many Canadian industries that have relatively high levels of foreign participation. An important concern for the review agency should be whether the acquiring firm is a large multinational which has a dominant position in foreign markets and is seeking similar anti-competitive advantages in Canada.¹⁹⁸ Existing Canadian merger laws are virtually unenforceable, because they must be applied through criminal law procedures which require proof beyond a reasonable doubt of future anti-competitive consequences.¹⁹⁹ Unconstrained by the procedural safeguards of the criminal law, the foreign investment regulators should use their economic expertise to assess the impact which the foreign takeover is likely to have on future competitive conditions in the Canadian market.

A second major problem with the review process is its lack of openness to external scrutiny. The Mulroney government's reforms exacerbate this deficiency by moving the final decision on foreign takeovers down from the cabinet to a single minister.²⁰⁰ At least when the decision was made by the cabinet as a whole, other departments had the opportunity of scrutinizing investment proposals and of raising issues which might not have received adequate attention in the agency staff's memo to the cabinet. It is probably true that the cabinet is simply too busy with more important matters to conduct routine detailed examinations of proposed takeovers; but there is a substantial risk of arbitrary and erroneous decisions if only one minister is assigned the exclusive responsibility for making these necessarily subjective judgments.

An effective solution would be to create a quasi-judicial tribunal for the role of reviewing proposed foreign takeovers. This reform would ensure that foreign investment review proceedings would be conducted in public, with full disclosure of all the non-confidential information pertinent to the takeover. This change would also allow public interveners to be heard on controversial applications, and it would permit the tribunal to provide written reasons setting out the economic or other policy justifications supporting its decisions. Some procedural safe-

guards for preventing the disclosure of valuable proprietary information to business rivals would be required, but these protective measures could be made compatible with open proceedings. Existing regulatory tribunals, such as the Anti-Dumping Tribunal, often encounter similar problems of safeguarding the confidentiality of business information, and they have successfully formulated procedures for limiting the scope of disclosure and ensuring that legitimate interests are protected.²⁰¹

In addition to these improvements to the existing system of prior approval regulation, the government should devote more resources to the collection and analysis of information that would permit more accurate comparisons between the performance of foreign-controlled and domestic firms. Existing provisions of the *Combines Investigation Act* provide the federal cabinet with broad powers to counter the adverse consequences of foreign governments' policies or informal directives aimed at Canadian subsidiaries or affiliates of multinational companies. Section 31.6 of the act prohibits a parent company from giving directives to its subsidiary for the purpose of implementing a foreign law or policy directive.

The main problem is that these remedial powers have not been complemented by any systematic monitoring or investigative efforts aimed at foreign-controlled firms. Effective regulatory intervention by cabinet would be facilitated by imposing on all large firms, both foreign and domestic, certain standardized reporting requirements. Over the past two decades, a number of informal "codes of conduct" for foreign-controlled firms have been promulgated by the federal government, and these documents identify most of the performance criteria on which data should be collected, such as technology transfers, export sales, and the sourcing of inputs.²⁰² Moreover, these annual reports should be designed to focus on a limited number of quantifiable measures of enterprise performance which are sufficiently standardized to permit comparisons between groups of foreign and domestically controlled firms.²⁰³

To sum up, foreign-controlled firms should in general be governed by the same tax and regulatory policies that are applicable to domestically controlled firms, except in a limited number of sensitive sectors where cultural or national security interests predominate. This basic principle of "national treatment," or non-discrimination, in regard to foreign investors is emerging as a customary norm of international law, and Canada has recognized it by formally assenting, in 1976, to the OECD Declaration of International Investment and Multi-National Enterprises.²⁰⁴ The OECD convention recognizes that a national commitment to equal treatment is consistent with the use of selective regulatory instruments when foreign-controlled firms take major business decisions which are adverse to national interests and which cannot be justified by legitimate cost and demand considerations.²⁰⁵ Canada

should promote this economically based standard of "national treatment" in its future multilateral and bilateral negotiations concerned with the regulation of foreign investors. In particular, any future Canada-U.S. free trade agreement should incorporate this non-discrimination standard and should also provide for a settlement procedure for bilateral disputes, in order to ensure its even-handed application.

The Legal Framework Governing Technology Transfer through Licensing

Arm's-length transfers of technology are regulated and shaped by a diverse range of contract, property, tort, tax, patent, trademark, anti-combines, and other national laws. Canadian laws affecting technology transfer are a prominent feature of external economic relations, because most of the commercially valuable technologies employed in Canada are imported from abroad. Since Canadians produce a relatively small proportion of the marketable technologies they use, one plausible strategy for increasing national economic welfare is to design the domestic legal framework governing technology transfers to promote consumer interests over producer interests. For example, by limiting the ability of foreign patent holders to impose restrictive conditions on their licensees, federal patent and anti-combines laws could be employed to enhance the bargaining power of Canadian users of technology, and thus to improve the terms of trade on inward flows of innovative ideas. Technology users can also be favoured through selective government intervention that reduces the price they must pay for imported ideas and techniques, usually referred to as compulsory licensing proceedings. In the limiting case, Canada might choose to become a technology outlaw nation and refuse to enforce any intellectual property rights recognized by other developed countries. Since 95 percent of the patents registered in Canada are owned by foreign residents or by corporations domiciled abroad, an outlaw strategy would redistribute a substantial amount of wealth from foreigners to Canadians.²⁰⁶

A legal framework that is systematically biased in favour of technology users will, however, discourage technology producers from locating in Canada. It is often argued that Canada's economic future depends on a major shift toward greater indigenous production of economically exploitable innovations. This argument turns on the relative importance of the competitive advantage of being the firm that first invents and exploits a new product design or production technique.²⁰⁷ If innovations cannot be cheaply and quickly copied by firms in other nations, the possession of firms on the leading edge of new technological developments should make a substantial contribution to national industrial development. There is therefore a plausible case that laws regulating the rights and duties of technology owners should be designed to create

positive incentives for Canadians to undertake more fundamental and applied research. From the standpoint of economic efficiency, it is an empirical question whether the net benefits from a moderately pro-consumer policy would outweigh the benefits attainable from a regulatory scheme that was more favourable to technology producers. To the extent that international legal norms limit Canada's ability to discriminate between foreign and domestic owners of marketable technologies, the design of laws governing technology transfers needs some compromise between the interests of consumers and producers.

Certain types of widely used intellectual property rights — patents, trademarks and copyrights — have been the subject of multilateral treaties and conventions since the later part of the last century. For example, the Patent Cooperation Treaty of the Paris Union Convention of 1883 created a legal framework for the reciprocal recognition of national patent rights and proscribed many forms of discrimination aimed at foreign patent holders.²⁰⁸ Canada is a signatory to the patent convention, as well as to similar treaties governing trademarks and copyrights. These international agreements do not, however, require the complete harmonization of national intellectual property legislation. Moreover, international law permits selective national regulation to control the unfair use or "abuse" of patents and trademarks.²⁰⁹ Thus, Canada has ample legal room to manoeuvre, and it can implement regulations that implicitly discriminate against foreign owners of technology without having to repudiate its existing treaty obligations. Despite the permissive nature of the international legal framework governing technology rights, past Canadian governments have generally not attempted to discriminate against foreign patent and trademark holders, nor have they designed the domestic legal framework to incorporate any observable bias in favour of technology users. The key issue is whether existing Canadian laws and regulations governing technology rights should be modified to reduce the bargaining power of their owners and to redistribute wealth to their users. The current controversy among academic economists about the consequences, in terms of efficiency, of pro-producer as opposed to pro-consumer regulation suggests that a purely economic approach to this question is unlikely to provide clear practical guidance for future laws and policies.²¹⁰

Two recent types of proposal for reducing the legal rights of patent and trademark holders illuminate the advantages and disadvantages of a general shift toward a legal framework which would be more oriented to the welfare of technology purchasers. The first strategy would expand the enforcement of existing legislative provisions, authorizing the diminution or revocation of patent or trademark rights that are used improperly by their owners. The second would amend existing federal anti-combines legislation to prohibit the inclusion of restrictive or anti-competitive terms in patent and trademark licences. Most of the merits

and limitations of these complementary strategies raise similar analytic problems.

The core problem arises from the absence of any economic or political consensus concerning the types of conduct which constitute an abuse of intellectual property rights. For example, the *Patent Act* provides, among other things, that it is an “abuse” of a patent holder’s statutory rights to fail to manufacture or license the production of the patented invention in Canada “without satisfactory reason,”²¹¹ to fail to meet consumer demand for the patented article “to an adequate extent and on reasonable terms,”²¹² and “to prevent or hinder the working of the invention on a commercial scale by importing the patented article.”²¹³ Under the act, a formal application may be filed by the attorney general or by any interested party (generally disappointed licence seekers), alleging that a patent registered in Canada has been abused. The commissioner of patents is empowered to compel the patent holder to grant a licence to applicants who succeed in establishing that acts or practices constituting an “abuse” have occurred.

This broad power to regulate abuses has been exercised only a dozen times in this century, excluding the special amendments governing the compulsory licensing of pharmaceutical patents, which were enacted in the early 1970s. Palmer and Aiello²¹⁴ found that there have been only approximately 50 applications brought under the patent abuse provisions since their inception in the *Patents of Invention Act* of 1906. Thus, despite the potential scope of such broad discretionary powers to restrict patent rights and to transfer wealth from foreigners to Canadians, this regulatory authority has been used very sparingly.

The *Patent Act*’s definition of abusive practices encompasses such a broad variety of commercial conduct that it obscures rather than clarifies the policy rationales underlying the regulatory scheme. For example, the patent holder’s failure to manufacture or license the production of the patented product may be animated by anti-competitive motives, such as the desire of competing licensees or patentees to block importation of the product. On the other hand, it is perhaps even more likely that the failure to “work” or license a patent in Canada is merely the result of unfulfilled hopes and an adverse judgment by the market. If a patent is commercially valueless, however, it is difficult to understand why anyone would bear the expense of applying for a compulsory licence and attempting to prove that the non-working or non-licensing of the patent was “without satisfactory reason.” Palmer and Aiello²¹⁵ conclude that the applicant’s absence of any reasonable commercial justification for non-working makes it very difficult for would-be licensees to win such cases. Moreover, the basic dispute centres on the potential profitability of employing the patented invention in Canada, an issue upon which the defendant patent holder (who does not bear the burden of proof) is likely to have superior information.

The cases decided under the *Patent Act*'s provision concerning "abuse" hold that owners should be required to license their patents when the commercial exploitation of the invention in Canada would yield a reasonable level of profit. In other words, applicants need not show that Canada is the most profitable location from which to satisfy a significant proportion of consumer demand for the patented product; they need show only that a competitive return on investment could be earned by working the patent in Canada.²¹⁶ Whether or not a competitive return is obtained also depends on the royalty rate negotiated by the successful applicant for a compulsory licence, and it seems clear that this selective case-by-case form of regulation could be readily employed to reduce the prices Canadians pay for foreign technology.

The regulation of patent abuse can therefore be seen to embody a number of at least partially conflicting rationales. One distinct conception of abuse focusses on anti-competitive or restrictive practices by patent holders. The regulation of such practices as the blocking of patents and the cross-licensing of patents among horizontal competitors can be justified on the grounds of economic efficiency or on the basis that they incorporate some moral code of commercial rights and duties. There are recurring controversies among experts about the efficiency of certain anti-competitive restrictions in patent and trademark licences; these are discussed briefly later in this section. They are, however, technical and empirical disputes which do not question the theoretical coherence of an efficiency-oriented approach to patent regulation.

A second conception of abuse centres on the fact that most patent holders in Canada are foreign residents or foreign-based multinational corporations. Foreign patent holders may be more susceptible to the influence of foreign governments and foreign interest groups with an economic stake in impeding the export of new technologies to Canada. For example, organized labour in the United States has frequently lobbied for more stringent controls on the export of technology rights and innovative capital equipment on the grounds that this would increase industrial employment in the United States.²¹⁷ While there is little evidence that the patent abuse provisions have been used for this purpose, *sub rosa* pressure from a foreign government, trade association, or union is one plausible explanation for the patent holder's failure to license or work the patent in Canada when it would be profitable to do so.

A third role for the patent abuse regulations is to provide a legal instrument for implicitly discriminating against foreign patent holders; in other words, for attempting to reduce the price Canadians pay for access to foreign technology. This rationale for selective intervention is also reflected in the existing statutory provisions mandating the compulsory licensing of pharmaceutical patents.²¹⁸ In the case of pharmaceuticals, there is no explicit discrimination against non-Canadian patentees, since virtually all the valuable patents in the industry are owned

by foreign residents. Compulsory licensing has cut deeply into the monopoly profits of multinational pharmaceutical companies and has saved millions for Canadian consumers.²¹⁹ Since Canadian consumption of prescription drugs is a very small proportion of the total world market for these products, a deep cut in patent holders' monopoly returns from Canadian sales may not exert much influence on their investments in research and development of new medicines. To the extent that Canadian consumers receive the benefits of advances in pharmaceutical technology without paying their share of the costs, compulsory licensing allows them to take a "free ride" on foreign consumers.

On the other hand, there is no objective standard for determining a "reasonable level" of monopoly profit for any particular patent right. There is no general agreement among economists concerning the level of monopoly reward required to induce the optimal level of research and innovative activity.²²⁰ For such goods as life-saving drugs, there is a difficult trade-off between making them accessible to consumers and keeping prices and monopoly profits high enough to encourage further medical breakthroughs. It is understandable that technology-exporting countries such as the United States and West Germany will favour higher returns for patent holders in Canada, or that they will at least oppose regulation designed to reduce monopoly returns below market-determined levels. In any event, this is a policy judgment upon which reasonable nations are likely to differ as long as most research and innovative activity in the West is concentrated in the United States, Western Europe and, increasingly, Japan.

There are several reasons why it is doubtful that compulsory licensing will be extended generally to other Canadian industries besides pharmaceuticals. First, compulsory licensing is difficult to enforce when knowledge that is indispensable to the production of a patented product cannot be readily ascertained from the formal patent documentation and from other publicly available sources of information. If the patent holder retains exclusive control over the "know-how" required to exploit the patented product or process, it will be difficult for administrators and judges to prevent selective and misleading disclosures to compulsory licensees. To a large extent, pharmaceutical patents are comparatively transparent to scientific experts, and no special proprietary knowledge protected by the common law of business secrets is necessary to exploit them. For the greater part of valuable commercial technology embodied in patents, this is not likely to be the case, and compulsory licensees would need access to expertise that is not readily available in the market, or in the published literature, in order to launch an effective competitive threat to established producers of the patented product.²²¹

A second important constraint on the large-scale use of compulsory

licensing regulation is the threat of retaliation from technology-exporting countries, especially the United States. U.S. retaliation may not be confined to Canadian patent holders, and the scope for damage to our major export industries should give pause to proponents of compulsory licensing. Moreover, retaliation against widespread compulsory licensing might also come from the private sector; many patent holders in Canada are multinational corporations that also own large Canadian manufacturing and distribution facilities. Threats by U.S. patent holders to close or contract their Canadian operations in retaliation for compulsory licensing regulation might be carried out in order to discourage other technology-importing countries from adopting similar policies.

Finally, a third constraint on the use of compulsory licensing as an instrument of Canadian economic policy is its probable adverse impact on research and development in Canada. International agreements prohibit discrimination between domestic and foreign patent holders, so compulsory licensing requirements would have to be applied to firms carrying on innovative activity in Canada.²²² This might discourage inventors, scientists, and entrepreneurs from coming to Canada; it might also promote the flight of local talent, since national immigration laws do little to impair the mobility of wealthy and creative individuals.

Given the limits of compulsory licensing as an instrument for encouraging inward transfers of technology, Canada's past policy of highly selective intervention to restrict patent rights probably makes sense. A regulatory scheme to control anti-competitive restrictions involving patent rights should be maintained, and in many cases the best practical remedy for unfair trading practices will be a compulsory licensing order. Moreover, foreign-based patent owners will tend to be more responsive to the policies and directives of foreign governments and interest groups than patent holders based in Canada will be. There is a role for selective regulatory authority to counter the influence of foreign policy directives, and the abuse provisions of the *Patent Act* are well suited to perform this function. The key issue in such cases should be whether the foreign-based patent owner has employed its statutory rights in accordance with reasonable commercial considerations, as opposed to extraneous political or strategic factors. For example, the compliance of multinational firms with the export control measures of foreign governments may involve management decisions that would be detrimental to subsidiaries based in Canada, and in some cases the most effective form of retaliation would be the compulsory licensing of foreign-owned patents registered in Canada. To the extent that existing legal doctrines of patent abuse go beyond anti-competitive practices and the control of foreign political influence, they provide protection to Canadian licensees and manufacturers, thus inducing inefficient production methods, as well as increasing the prices paid by consumers.

A second regulatory strategy for limiting the bargaining power of technology owners is to control the contractual terms that may be incorporated in licensing agreements. Patent and trademark licences often include restrictions or positive obligations aimed at increasing the profits earned by the licensors.²²³ For example, market restrictions (such as prohibitions on exports or imports of the patented or trademarked article) reduce uncertainty concerning future competition among licensees, and this enables licensors to charge higher royalty rates. Another example is a tying arrangement, which requires the licensee to purchase goods and services from the licensor for use as inputs in the production of a patented or trademarked product. Tie-ins of goods and services (which can be used to measure the extent of the licensee's willingness to pay for the technology) are effective instruments of price discrimination, and they permit licensors to increase their monopoly profits. A third example is a grantback provision, which requires the licensee to transfer exclusive, or in some cases non-exclusive, rights to any extensions or improvements to the licensed technology. Patent owners seek such provisions to reduce uncertainty about future competitive challenges from licensees, and in most cases they will agree to lower royalty rates or other less favourable terms in order to induce acceptance of grantback obligations.²²⁴

Market restrictions, tie-ins, and grantback obligations also create barriers to entry and restrain competitive rivalry. They discourage or prevent Canadian licensees from developing autonomous technological capabilities, and they retard the development of an export-oriented secondary sector. Existing Canadian regulation of anti-competitive licence restrictions is relatively permissive or liberal by the standards of Western developed nations. Federal combines law generally permits any type of restrictive provision in a patent or trademark licence, other than resale price maintenance clauses.²²⁵ The *Combines Investigation Act* confers broad powers on the federal courts to void patents and trademarks which are employed to "restrain or injure, unduly, trade or commerce," but these powers have only been exercised twice since they were enacted in 1919.²²⁶ The 1976 amendments to the act brought in new regulations governing tie-ins, market and territorial restrictions, and exclusive dealing arrangements — restrictive terms that are often incorporated in technology-licensing agreements.²²⁷ In the nine years since then, federal enforcement officials have not initiated a single case involving patent or trademark licences under the new regulations. Non-enforcement may be the result of a lack of complaints from licensees, who may be reluctant to jeopardize their business relationship with the licensor in order to have particular burdensome obligations invalidated. Without specific complaints, public enforcement of anti-combines regulations will be ineffectual, since these licensing agreements are confidential. Public notification and disclosure of licensing agreements may

be essential if there is to be effective control of the imposition of anti-competitive terms by licensors.

Stricter anti-combines enforcement should pay particular attention to the efficiency-promoting consequences of certain restrictive licence terms. Market restrictions can reduce the cost of transactions and can limit the scope of commercial risk assumed by the licensor; in a competitive market such as the global technology market, this means that licensees will pay lower royalty rates than they would in the absence of such restrictions. In some cases, it may be economically rational for a technology-importing nation like Canada to accept some anti-competitive restrictions imposed by licensors, despite their adverse impact on industrial development, in order to secure valuable technology at lower prices. Combines investigations should only be launched in cases where there are good reasons to believe that the efficiency-promoting effects of restrictive patent and trademark licence terms are fully offset by their likely harmful effects on Canadian industrial development.

The invalidation of restrictive terms in patent and trademark licences is a legal remedy with rather limited scope for potential application. To some extent, the effectiveness of this instrument depends on the existence of compulsory licensing powers, since the imposition of licensing terms that were overly disadvantageous to patent and trademark owners would cause them to refuse to grant licences at all. In other words, patent and trademark holders cannot be forced to register and apply for intellectual property protection in Canada; special proprietary knowledge, indispensable to the efficient use of the patent or trademark, may provide sufficient protection from potential Canadian infringers. Moreover, there is an obvious relationship between the severity of licensing restrictions and the incentive of foreign-based patent and trademark holders to exploit their rights through the Canadian manufacturing subsidiaries that are under their ownership and control. Stringent regulation of licensing agreements, holding the enforcement of all other laws constant, will increase the level of foreign ownership in Canadian secondary industries. As discussed earlier, there is also the threat of retaliation from technology-exporting countries if anti-trust regulation is used for the purpose of protecting local licensees from foreign competitors.

In the 1970s, UNCTAD sponsored the promulgation of a *Code of Conduct on the Transfer of Technology*, which would make illegal virtually all restrictive terms in patent and trademark licences per se.²²⁸ The main proponents of strict categorical prohibitions on restrictive licensing terms are the developing countries, who import virtually all their commercial technologies. Part of their argument for banning all licensor-imposed restrictions on the use of technology is that developed nations have a charitable obligation to assist in the economic development of poor nations, and that unrestricted transfers of commercial technology will lead to accelerated industrial growth in these countries.

Yet it is possible that stringent controls on restrictive terms will lead foreign owners of technology to raise their royalty rates or to license their knowledge in other more permissive jurisdictions. Countries subscribing to the philosophy of the UNCTAD code will also run the risk of driving out their most creative and technologically sophisticated citizens, unless some other policy to compensate for the disincentive effects of these overly restrictive regulations is deployed.

Federalism and Foreign Economic Relations

Introduction

The main economic challenge for Canadians is to transform the structure, and consequently the performance, of our national economy in order to compete successfully in an increasingly demanding world trade environment. For a small, open economy, external trade policy must play the leading role in facilitating the industrial adjustments required. To summarize a basic policy prescription advanced earlier, secure access to export markets will be an indispensable first step in triggering the investment decisions that will be needed to fuel Canada's economic transformation.

Improved access to foreign markets can, however, only be achieved through the reciprocal reduction of Canadian barriers to imported goods and services. While border measures, such as tariffs and quantitative restrictions, fall within the exclusive jurisdiction of the federal government, many non-tariff barriers arise from laws and regulations adopted by provincial governments; such non-tariff barriers include government procurement practices, subsidies to local industries, and consumer product standards. The effective representation of Canadian interests in future multilateral and bilateral trade negotiations will require the federal and provincial governments to achieve a consensus on the substance of the commitments to be offered and the methods to be employed when implementing treaty obligations.

The existing constitutional design for allocating legislative powers between the coordinate levels of Canadian government is predicated upon a high degree of jurisdictional overlap and shared responsibility for the diverse range of policies which impact on foreign economic relations. The recent expansion of international law-making activity into areas of provincial legislative competence has coincided with the steady growth of provincial programs and regulations covering activities such as agriculture, manufacturing, and resource development which are closely linked to external trade and investment flows.²²⁹ The taxes, subsidies, and regulations employed in pursuit of provincial industrial policy objectives have frequently been used to control inward flows of goods and capital, in accordance with the interests of politically influen-

tial producer groups concentrated in particular provinces. There is a risk that future jurisdictional disputes may arise if provincial economic or social policies conflict with federal initiatives to remove (or to reduce the restrictive effects of) laws and regulations which limit access to the Canadian market.

In light of the challenging agenda of foreign economic policy issues that must be confronted in the coming decades, it is essential to assess the potential impact of Canada's highly decentralized federal system of decision making on the effective management of external economic relations. What are the advantages and disadvantages that are inherent in the conduct of foreign economic relations under our existing federal legal structure? If the current scheme of overlapping legislative powers is a substantial impediment to the achievement of our external economic policy goals, what institutional reforms hold out the prospect of superior results?

In this section of the study we shall attempt to answer these questions by identifying and analyzing the major provincial laws and regulations that are likely to figure prominently in future multilateral and bilateral trade negotiations. The key issue is whether the federal government could act unilaterally to supersede or nullify provincial legislative or administrative acts which conflict with the obligations imposed by validly contracted international economic treaties. In light of the existing constitutional limitations on federal authority to implement international agreements, we shall examine the prospects for effective cooperation between the two levels of government in the absence of any major legal or institutional changes in the current balance of constitutional power. We shall then assess several options for reform, designed to enhance our nation's capacity to act decisively in securing the maximum potential benefits from global economic development.

Provincial Non-Tariff Measures

Provincial taxes, regulations, and subsidies that protect industries enjoying the economic salience and political influence to win strong support in provincial cabinets are often referred to as "non-tariff measures."²³⁰ This approach of classifying laws and regulations with discriminatory consequences is somewhat confusing, because many of these measures, such as tariffs on imports, involve explicit discrimination against foreign producers — and, in many cases, against out-of-province producers. For example, provincial government procurement regulations often include explicit provisions stating that preference must be given to contractors who conduct a substantial proportion of their business activities within the province concerned. Similarly, there are provincial statutes or regulations which require mining and forestry companies to process or refine their raw materials before exporting them

beyond provincial boundaries. Provincial policies that provide implicit protection against imports include such measures as industrial subsidies that displace imported products, and product content and design standards that impose unnecessary cost burdens on foreign producers of competing goods.

Explicit forms of protection are usually more amenable to economic analysis and to quantification of their actual consequences for industrial efficiency and income distribution. However, this is not always the case, since some policies of explicit protection may be administered through highly discretionary and confidential executive decision-making processes, e.g., government contracting, natural resources licensing, government liquor distribution, etc.

Implicit protection is often the result of policies and programs that are designed to protect consumers from unsafe products, or to prop up declining industries in order to ameliorate the social and human costs of long-term unemployment. Whether discrimination against imports is an intended or unintended consequence of subsidies or regulations, negotiations to limit these barriers can be politically controversial if provincial producers, who benefit from the implicit protection, can enlist the aid of interest groups attracted by the social and humanitarian aims of these measures.²³¹

The following summary of provincial non-tariff measures is not an exhaustive catalogue; rather, it represents an effort to identify the major legal forms of trade protection at the provincial level and the basic types of economic activity affected by them. This representative survey of provincially induced barriers to imported goods and services is derived from recent studies which have focussed primarily on government-created impediments to interprovincial trade. These studies indicate that the majority of provincial industrial policies, which aim at creating new industries or easing adjustments in declining sectors, injure more efficient producers in other provinces as severely as they harm foreign competitors.²³² Thus, many of the provincial laws and regulations surveyed here raise serious concerns, not only for future trade negotiations but also for the integration and efficiency of Canada's internal economic union.

The emphasis on provincial non-tariff measures in this part of the study should not be taken to suggest that central government policies have minor or secondary impacts on the interprovincial distribution of economic activity and income. Federal tariffs, energy taxes, and transport subsidies benefit consumers and producers in some regions and in particular provinces while imposing their costs on others. Recent calculations done by Whalley²³³ suggest that federal taxes and subsidies create more costly impediments to national economic integration than provincial non-tariff measures, and that these measures are also likely to

figure prominently on the agenda for future multilateral and bilateral trade negotiations.

To an unknown but probably significant extent, provincial non-tariff measures have been motivated by a desire to countervail federal trade, tax, and regulatory policies with regionally discriminatory impacts. This pattern of federal-provincial conflict over the speed and direction of economic development reflects one of the primary disadvantages of an overlapping scheme for the sharing of legislative powers between the two levels of government in a federal structure. In effect, each level of government retains the constitutional authority to obstruct or neutralize progress toward policy goals established by the other.²³⁴ For a small, open economy, faced with intensifying competition in its domestic and export markets, a coherent and comprehensive approach to defining government's promotional and regulatory role in economic development is likely to be of increasing importance in future decades. The following outline of provincial non-tariff measures demonstrates the present scope for cross-cutting wasteful conflicts with federal policies.

PROVINCIAL PURCHASING POLICIES

Preferences for within-province contractors in bidding for government purchases of goods and services exist in all ten provinces.²³⁵ Discrimination in favour of provincial suppliers is achieved through a wide variety of techniques. The most explicit methods involve residency or place-of-manufacture requirements employed either as a condition for participation in the bidding process or as the basis for granting a cost preference to local suppliers (which is usually expressed as a percentage of the value of the contract involved). Most procurement regulations that provide for specific levels of explicit protection also incorporate vague discretionary standards which permit purchasing officials to grant additional preferences to local firms in competition with out-of-province suppliers. For example, Quebec's purchasing policy establishes a 10 percent margin of preference for Quebec-based firms; but it also provides for an additional unspecified degree of favouritism for local firms when awarding them the contract, if the contract would promote provincial "industrial development objectives."²³⁶ The order-in-council setting out Quebec's procurement rules does not define what is meant by "industrial development objectives"; this legal ambiguity allows the executive and administrative officials who manage procurement policy to choose the degree of preference to be accorded to local suppliers on a wholly case-by-case basis.

Most provincial purchasing policies implicitly authorize systematic discrimination in favour of local suppliers, merely by conferring broad discretionary powers on cabinet ministers to award public contracts.

There are various administrative techniques employed to conceal discrimination against out-of-province bidders:

- the tailoring of performance requirements in formal invitations for tenders so that they match the technical capabilities or pre-existing proposals of within-province firms;
- the use of selective or “single tender” schemes that incorporate discriminatory methods for choosing “qualified” bidders; and
- various procedural barriers, such as inadequate publicity about information on bidding opportunities, or very short time limits for the submission of bids.²³⁷

The most effective legal strategy for controlling discrimination in procurement systems aims directly at curbing the discretionary authority of ministers and departmental officials. To achieve such constraints, there would need to be external audits, independent review bodies, and mandatory reporting, as well as “transparency requirements” such as the provision of written reasons for awarding contracts, and standardized rules about the amount of notice to be given and about the disclosure of information.²³⁸ Future multilateral and bilateral trade negotiations are likely to involve proposals that both central and sub-national governments should undertake to impose some or all of these legal controls on their procurement processes.

The new GATT code on procurement, which was discussed briefly earlier, enacts a fairly weak anti-discrimination regime, although it does take some significant first steps toward improving transparency and thereby controlling discretionary acts of favouritism. During the negotiation of this code, the federal and provincial governments consulted on the prospects for mutual commitments to limit discriminatory procurement practices, but at the conclusion of the trade talks it was agreed that it was inadvisable to offer specific provincial undertakings to implement the code. Rather than offer a binding commitment on behalf of the provinces, Canada merely repeated its pre-existing obligation under Article XXIV (12) of GATT — to use its “best efforts” to promote provincial compliance with the procurement code.²³⁹ Since the code’s safeguards apply only to purchasing “entities” designated by the signatories, and since Canada has not designated any provincial department or Crown corporation as being covered by the code, the question of provincial compliance has not arisen under the GATT dispute settlement procedure.

Given the approximately \$40 billion annually that is spent by provincial governments for goods and services, future trade negotiations are certain to involve requests by trading partners for improved access to procurement markets.²⁴⁰ Since most provincial governments own or control a wide variety of commercial enterprises (airlines, hydro companies, telephone companies, universities, railways, hospitals, etc.), discrimination in purchasing at the provincial level encompasses a large

number of products and services that are exported by the United States and the EEC.

REGULATED SERVICES

Motor Vehicle Transport

Since 1954, the provinces have exercised regulatory authority over the interprovincial and international carriage of goods and passengers by trucks and buses. Provincial control is inconsistent with the ostensible division of powers enacted by section 92(10) of the *Constitution Act, 1867*. This interpretation was endorsed by the Supreme Court's 1951 decision in *Winner*, which dispelled any doubts concerning the federal government's exclusive jurisdiction over interprovincial motor vehicle traffic.²⁴¹ Nevertheless, the federal Parliament declined the opportunity to impose a uniform scheme of regulation, and it enacted explicit legislation, now more than 30 years old, delegating its constitutional responsibility to the provinces.²⁴²

As a result, each province is able to control the activities of truck and bus carriers operating within its boundaries, even if the carriers only pass through the province on interprovincial trips. Since all of the provinces currently exercise their authority to regulate entry, there are ten different sets of motor carrier regulations across Canada. Recent studies on interprovincial motor carriage conclude that most barriers to competition occur as a result of lack of uniformity among provincial regulations and taxes, rather than from deliberate discrimination against out-of-province carriers.²⁴³

The main concern for external trade relations is the treatment accorded to U.S. carriers who apply to provincial regulatory boards for licences to offer their services to Canadian shippers and passengers. Some provinces discriminate against U.S. carriers by prohibiting firms controlled by foreign residents from holding both intraprovincial and extraprovincial operating licences. Others have allegedly adopted tacit policies of refusing carriage licences to U.S. applicants.

For example, the Ontario Highway Board possesses broad discretionary powers to control entry to all commercial vehicle routes in the province.²⁴⁴ During the 1970s, there were several notable instances in which U.S. carriers were either denied permission to enter the Ontario market or were granted operating licences with special route and customer restrictions that were designed to protect Canadian licensees.²⁴⁵ In 1980, the U.S. government made formal complaints concerning the Ontario board's alleged discrimination against U.S.-owned trucking firms and threatened retaliation against Canadian truckers, most of whom derive a significant amount of revenue from transborder shipments. Since these complaints were subsequently settled through confidential negotiations and an exchange of notes, there was never any

definitive finding on whether or not the Ontario board was discriminating against U.S. firms.²⁴⁶

Objective evidence of an intent to discriminate by government regulators is often difficult to obtain in this type of trade dispute. The U.S. trucking complaints in 1980 and 1981 coincided with a recessionary market environment and with surplus capacity problems for Canadian carriers. If most Canadian applicants for route licences were also being denied entry into the market during this period, proof that no U.S. applicants were granted licences, without additional corroborating evidence of discriminatory intent, would not have established a very persuasive claim for remedial action.

The difficulty of proving discrimination in a regulatory activity such as licensing can be compared to the enforcement problems emphasized earlier in regard to provincial procurement decisions. When foreign producers can be excluded from markets through the exercise of discretionary powers which permit officials to act on subjective judgments founded on vague statutory criteria, a substantial amount of implicit discrimination against foreign bidders and licence applicants is virtually inevitable. The only effective legal technology for limiting this form of discrimination is to constrain official discretion by imposing more concrete decisional standards and more transparent procedures.

In future external trade negotiations, it is probable that the provinces will be asked to accept these more effective controls on their ability to grant implicit protection to resident producers.²⁴⁷ Whether the federal government could accept a treaty obligation to impose such anti-discrimination measures, and whether it could subsequently compel dissenting provinces to conform, is a question that is best deferred until later in this study, when we analyze the constitutional issues. In regard to the provincial licensing of extraprovincial motor carriage, no difficult constitutional questions are involved, since the federal government need only repeal the 1954 statute which delegates its legislative powers over these activities to the provinces.

Financial Services

There is a close functional link between regulations aimed at tradable services and laws concerning foreign ownership of particular types of business. In the field of financial services, such as insurance, banking, and investment brokerage, the two types of regulation are indistinguishable in a practical sense, because foreign firms must establish local outlets or branches in order to market their services in a commercially viable manner. The provinces generally exercise constitutionally valid control over financial institutions other than banks, including savings and trust companies, investment dealers, consumer lending firms, and insurance companies.

Explicit discrimination against foreign financial firms occurs in many provinces through statutory provisions barring foreign-controlled businesses from entering regulated financial services markets.²⁴⁸ Moreover, it has been asserted that discriminatory policies are tacitly imposed to keep American security dealers and insurance firms out of some provincial markets.²⁴⁹ Provincial regulation over financial services does not, however, usually extend to direct controls on the number of firms permitted to enter local markets, and therefore it does not generally provide the broad discretionary power required to implement an effective policy of tacit discrimination against foreign entrants. Nevertheless, the U.S. government has indicated that, in future comprehensive trade talks with Canada, it will attempt to negotiate for the removal of foreign-ownership restrictions applicable to the financial services industries.²⁵⁰

AGRICULTURAL POLICIES

All the provinces employ three basic legal instruments to protect local agricultural producers: agricultural marketing boards, agricultural subsidy programs, and restrictive product standards and quality regulations. The marketing boards operated by the provinces are organized under federal legislation, the *Farm Products Marketing Agencies Act*.²⁵¹ This act authorizes the federal minister of agriculture to create national supply management regimes for particular agricultural commodities when a substantial majority of Canadian producers favour quotas. When controls are imposed on a product, the act requires the creation of a federal agency to establish a national quota and to allocate shares of production among the provinces. Provincial marketing boards allocate production quotas among their resident producers, and manage eligibility and enforcement matters. Currently, there are five products regulated under the federal scheme: wheat, eggs, chickens, turkeys, and industrial milk.

Since the federal government has exclusive constitutional jurisdiction to apply quantitative restrictions on products moving in international commerce, provincial supply management for most agricultural products would be ineffectual without federal quotas to exclude lower-cost U.S. producers. Therefore the federal government's ability to withdraw indispensable trade protection from provincial supply control schemes increases its bargaining leverage to secure provincial government compliance with international trade agreements concerning agricultural products.

Provincial supply management boards can create barriers to out-of-province and American producers by enacting discriminatory rules concerning the distribution and marketing of agricultural products. Since marketing, distribution, and processing are economic activities that usually take place wholly within provincial boundaries, there is

broad constitutional scope for protecting in-province producers by means of transport and handling regulations, testing procedures, grading and labelling standards, and health regulations which implicitly discriminate against out-of-province and American suppliers.

In some cases, discriminatory regulations can prevent any trade with out-of-province suppliers. For example, the Ontario Milk Board requires all producers to be inspected by provincial inspectors before they can sell milk in Ontario, but the inspectors will not travel to conduct inspections outside the province.²⁵² More frequently, provincial regulators adopt different product standards or different packaging requirements — a measure which increases the added cost burden that out-of-province suppliers face when entering local markets and which thus protects the local firms' share of the market. A recent study by Haack, Hughes, and Shapiro²⁵³ identifies dairy product standards, packaging rules, vegetable grading standards, and fruit and vegetable inspection practices as non-tariff measures which are currently employed by provincial governments to restrict trade in agricultural products.

In addition, many provinces have established subsidy programs to assist local producers in competing with out-of-province suppliers. Most of this aid to resident farmers takes the form of direct cash grants and subsidized credit. A recent study based on 1981 data estimated that the provinces now pay an annual average per capita subsidy of about \$50 to the farm products sector.²⁵⁴ Moreover, most provinces also maintain promotional support programs, which use advertising and other marketing strategies to differentiate local products from out-of-province substitutes. As we shall show later, the existing division of federal-provincial powers may effectively insulate these direct and indirect subsidies from any form of unilateral federal control.

NATURAL RESOURCE POLICIES

Most provinces employ a number of complementary legal instruments to promote and protect domestic natural resource industries. First, all provinces levy some form of mining or severance tax on income derived from natural resources, and most grant "processing allowances" which permit firms to deduct, from income which is subject to mining taxes, a specified percentage of the costs of processing or manufacturing assets used within the province; this tax deduction is denied to taxpayers with out-of-province facilities.²⁵⁵ Several provinces have also attempted to increase the local processing of natural products by imposing direct taxes on the export of unmanufactured natural resources. For example, British Columbia taxes raw timber exported from the province, in order to depress the domestic log prices that are paid by local processors and to bring them down to below world market levels.²⁵⁶ Moreover, the *British Columbia Mineral Processing Act* requires that all B.C. minerals

be processed in the province if appropriate facilities have unused capacity, and it authorizes the responsible minister to issue directives compelling mining and mineral firms to comply with this requirement.²⁵⁷ Alberta, Saskatchewan, Quebec, and New Brunswick have similar policies regarding the processing and extraprovincial shipment of natural resources.²⁵⁸

Another way in which provinces can shape the development of their resource industries is through direct subsidies and tax deductions related to exploration and allied costs. These subsidies and tax exemptions can have significant impacts on external trade flows, because of the relatively high proportion of natural resource exports from many provinces. Several of the largest recent U.S. cases concerning countervailing duties have involved Canadian natural resource and agricultural products: softwood lumber, fish, potatoes, and pork. All four industries receive direct or indirect aid from various provincial governments, depending on their relative political influence in particular provincial cabinets and legislatures.²⁵⁹

INDUSTRIAL SUBSIDIES

All the provinces have a variety of incentives to attract new industries or to prop up old ones. These industrial subsidies encompass grants, loans, loan guarantees, and equity investments by provincially owned or controlled financial institutions. They also include indirect forms of assistance, through government supply of support services, infrastructure investment, research and development projects, and export market development services. To an increasing extent over the past decade, provincial assistance programs have received substantial amounts of federal funding under a federal-provincial arrangement called the General Development Agreements.²⁶⁰ Each of the provinces signed a cost-sharing agreement with the federal Department of Regional Economic Expansion (DREE) under the Trudeau government, and it appears that the Mulroney government will continue these arrangements for coordinating subsidy programs.

Although provincial incentive programs involving federal cost-sharing account for most direct forms of assistance, a substantial amount of provincial aid is also provided through special deductions and exemptions from corporate income taxes. Moreover, many provincial cabinets have adopted the practice of granting subsidies on an ad hoc basis to attract out-of-province investors or to bail out insolvent local enterprises. Incentive packages offered to foreign investors by one province often trigger competing bids from other provincial governments. The federal government has been required to act as a mediator in several recent disputes between provinces over competing bids to attract new projects in the manufacturing and high-technology sectors.²⁶¹

PROVINCIAL LIQUOR POLICIES

All the provinces maintain some degree of monopolistic control over the distribution and marketing of alcoholic beverages. Provincial liquor boards have adopted several types of discriminatory practice designed to protect local producers of liquor, wine, and beer. British Columbia, Ontario, and Quebec allow locally produced beverages a preferential price mark-up.²⁶² For example, in British Columbia local table wines are marked up by only 50 percent, while similar wines imported from abroad or from other provinces are marked up 110 percent.²⁶³ Provincial liquor outlets also favour local products by providing preferential advertising and promotional support, such as the carrying of larger inventories and more varieties of domestic beverages. For example, wines produced outside Ontario can only be distributed through provincial retail stores, while Ontario wineries may also sell through their own retail outlets.²⁶⁴ There are approximately 150 winery-owned outlets currently operating in Ontario.

During the Tokyo Round, Canada negotiated for improved access to United States and EEC markets for bottled and bulk whisky exports. The Europeans and Americans countered with proposals for reducing provincial discrimination in the retailing of imported alcoholic beverages. Federal-provincial consultations on these proposals concluded with a joint "statement of intent," endorsed by all ten provincial governments. The statement contained two basic commitments on preferential pricing for local products. The first was that mark-up differentials between domestic and imported distilled spirits could only be based on "normal commercial considerations" (e.g., higher handling or marketing costs); the second was that mark-up differentials between domestic and imported wines would be frozen at 1979 levels, unless a future increase could be justified by "normal commercial considerations."²⁶⁵

Since the Tokyo Round, signatories of the statement have disagreed about its legal consequences for the provinces. Both federal and provincial participants in the Tokyo Round have agreed that the statement was not meant to create any formal legal obligation for the provinces, either to Ottawa or to Canada's trading partners. Recent federal governments have resisted the notion of any provincial constitutional authority to conclude valid treaties with foreign nations.²⁶⁶ Moreover, both Ottawa and the provinces have been reluctant to press the issue of the legal enforceability of intergovernmental agreements, in part because of a mutual desire to avoid a zero-sum conflict serious enough to endanger the large number of similar federal-provincial arrangements.

In a formal complaint under the GATT dispute settlement procedure, the EEC has recently advanced an interpretation of the statement which conflicts with the federal-provincial position. The EEC complaint challenges certain changes to Ontario's wine-pricing rules, introduced in

1982 and 1983, on the ground that they violate the obligations imposed on provinces by the Tokyo Round statement.²⁶⁷ These changes preserved the mark-up differentials between Ontario wines and imported wines at 1979 levels, as required by the agreement, but also imposed a new "handling charge" of 65 cents per bottle of foreign wine, compared with 25 cents per bottle of domestic wine. When the handling charge was first initiated in 1982, the EEC, supported by the United States, protested that the higher charge could not be justified in terms of any extra real costs entailed in marketing foreign wines, and that it amounted to thinly disguised intentional discrimination.

In 1983, after the United States indicated that it was considering retaliation against Canadian whisky imports, Ontario removed the discriminatory charge on foreign wines; but, at the same time, it instituted a new system of "minimum reference prices." While the minimum prices apply uniformly to domestic and imported wines, the EEC argues that discriminate implicitly against the cheaper brands of European wine. The EEC claims that Ontario's current minimum-price scheme virtually forecloses the provincial market from the cheapest brands of Italian and Spanish wine, and that the only logical motivation for the floor prices is to protect local wineries.²⁶⁸ French, German, and American wines have not been adversely affected by the 1983 pricing changes, because they are virtually all marketed in the medium- and higher-priced categories.

The EEC complaint against Canada raises the issue of Ottawa's legal obligation to attempt to secure provincial compliance with international trade agreements. Article XXIV(12) of the GATT requires a national government to "take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territory." Since there are no direct precedents on the meaning of the GATT's "best efforts" rule for federal states, the EEC claim raises novel questions concerning the coercive measures which Ottawa may be legally compelled to take against provinces that refuse to implement GATT rules.

If Ottawa believes that Ontario's minimum reference prices violate Canada's treaty obligations, does Article XXIV(12) require the federal government to initiate a formal constitutional challenge to the provincial rules? The option of legal proceedings against Ontario is certainly a measure that is available to Ottawa, and the outcome of a constitutional challenge to the minimum price scheme is so uncertain that it would be reasonable to require the federal government to test the limits of its authority to secure Ontario's compliance. The central legal issue in the EEC's complaint devolves into a question about the division of legislative powers under the *Constitution Act, 1867*. In short, if Ottawa had the constitutional authority to compel Ontario to cease discriminating against EEC wine, and if it failed to do so, then it would have violated the "best efforts" obligation of Article XXIV(12). On this interpretation of

the “best efforts” obligation, the GATT panel will be required to adjudicate the issue of whether Ontario’s allegedly discriminatory pricing scheme for wine is ultra vires the scope of its legislative powers under Section 92 of the *British North America Act*. The next part of this study considers this question.

Constitutional Doctrine

The *Constitution Act, 1867* contained no general grant of legislative authority regarding the Dominion’s external affairs, apart from Section 132, which only empowered the federal government to implement the treaty obligations of Canada or the provinces under agreements between the British Empire and foreign nations.²⁶⁹ When Canada became a fully independent member of the international community, Ottawa claimed the exclusive authority to conclude treaties with foreign nations.

While this federal claim to plenary treaty-making power has been challenged by Quebec over the past two decades, the courts have not yet been asked to decide whether provincial governments can negotiate and ratify international agreements on their own behalf.²⁷⁰ The view adopted by a majority of commentators on this issue is that the royal prerogative power to conclude treaties was transferred by Britain to Canada alone, and that the federal cabinet therefore possesses the exclusive authority to create legally binding international obligations. Moreover, the Supreme Court of Canada’s 1984 judgment in the *Newfoundland Off-Shore Mineral Rights* case acknowledged Ottawa’s exclusive competence to conclude treaties and represent Canada in international forums, which suggests that the federal government would be likely to succeed in any direct challenge to provincial treaty-making.²⁷¹

The Privy Council’s controversial decision in the *Labour Conventions* case held that the other component of legal authority over external relations — the power to implement treaties — is divided between the two levels of government, in accordance with the *Constitution Act, 1867*’s general scheme for allocating subject matter jurisdiction.²⁷² For example, because Section 92 gives the provinces exclusive jurisdiction over property and civil rights, provincial governments can refuse to adopt legislation or regulations necessary to implement treaty obligations concerning these legislative subjects. The *Labour Conventions* doctrine denies the existence of any category of autonomous power to legislate for the purpose of implementing treaties. This conception of treaty implementation is consistent with the absence of any express provision for such a power in the *Constitution Act, 1867*.

Moreover, the denial of any implied federal power to implement treaties is consistent with a basic idea that is reflected throughout the division of powers jurisprudence — that constitutional provisions granting Ottawa broad general powers without objectively definable limits are

to be given a narrowing construction in order to preserve a broad sphere of provincial regulatory autonomy. For example, federal powers over “trade and commerce” and over matters affecting the nation’s “peace, order and good government” have been accorded limited scope in order to expand the purview of provincial jurisdiction over such subjects as property and civil rights, and matters of a local nature. Whyte’s recent study²⁷³ concludes that the basic legal conception of Canada, reflected in the division of powers cases, is a federal community of partially autonomous, partially subordinate, states. Whyte argues that this basic normative conception of the Canadian federation has led the courts to diminish the potential reach of the centralizing powers in Section 91 of the Constitution in order to give effect to the notion of separated powers, an idea reflected in both the words and the logical structure of the text. The absence of any general federal power to implement treaties seems consistent with Whyte’s view of the division of power doctrines created by the courts.

Thus, the *Labour Conventions* principle directs that Ottawa’s authority to implement treaties, and to require provincial compliance, depends on whether the subjects regulated by particular treaties fall within recognized categories of federal legislative power. From the standpoint of trade treaties, the federal government’s exclusive jurisdiction over international commerce provides textual support for the view that any provincial measure that requires or permits explicit discrimination against imports or exports is ultra vires. Such provincial laws and regulations have been struck down, for example in the *Manitoba Egg* case,²⁷⁴ because they aim directly at the extraprovincial flow of commerce. Recent work by Fairley suggests that while provincial taxes and regulations which expressly discriminate against foreign producers would generally exceed provincial authority, the same result might not ensue in litigation challenging provincial procurement or subsidy policies that confer competitive advantages on local producers.²⁷⁵ The use of spending powers (such as procurement preferences and the broad range of direct and indirect subsidy programs discussed earlier) to protect within-province firms from foreign competitors has never been reviewed by the courts, and Fairley argues that the courts might reasonably decide to accord more latitude to provincial spending and proprietary activities than to local taxes and regulations that are explicitly protectionist.

For most provincial non-tariff measures, the constitutional question raised by conventional doctrine devolves into an attempt to characterize the true purpose of the local legislation or regulation; the actual economic consequences of the provincial measures are often given secondary weight in judicial analyses. For example, provincial subsidies that increase exports or reduce imports may be justified by reference to other constitutionally authorized aims, such as the provision of vocational training and stable employment. Provincial non-tariff measures which

protect local firms through implicit discrimination (such as consumer product standards that increase the costs of foreign entrants, or licensing schemes that conceal unequal treatment through vague discretionary criteria for granting licences) are even more difficult to characterize as being government actions that are motivated by the exclusive or primary objective of controlling international commerce.²⁷⁶ Monahan's analysis of the Supreme Court's trade and commerce cases shows that a variety of provincial measures, many of which generated substantial impacts on external trade, have been upheld because their extraprovincial effects were found to be merely incidental to the valid provincial purpose of regulating transactions or activities that were taking place entirely within the province.²⁷⁷ This approach to questions about the division of powers, which makes the legal outcome turn on the court's subjective characterization of legislative motives, allows broad latitude for judicial balancing of the competing arguments and interests favouring either federal or provincial control over important public policy decisions. Monahan's recent work demonstrates that this case-by-case approach has not required the courts to formulate any coherent theory of federalism that explains and justifies the existing constitutional division of powers over trade and commerce.²⁷⁸ Unlike Whyte, Monahan concludes that the overall result of the existing doctrine on the division of powers is a crazy-quilt pattern of overlapping legislative powers, which cannot be squared with any general organizing principle for assigning jurisdictional responsibilities within a modern federation.

The debate between Whyte and Monahan raises fundamental questions about the institutional competence of courts, and about whether the legal constraints imposed on judges preclude them from implementing any coherent normative view on the division of powers. These issues must be resolved in order to design effective arrangements for coping with jurisdictional conflicts between the two levels of government, and they are discussed in the next part of this study. The question being analyzed here is whether existing constitutional doctrine strikes the most desirable balance between central coordination and provincial autonomy, in making decisions linked with foreign economic relations. Whether Canada's overlapping scheme for allocating federal and provincial powers is normatively coherent or not, its main consequence in the field of external economic relations is that, through a range of policy instruments, provinces can ignore or can indirectly violate the provisions of international agreements concluded by Ottawa. What are the strengths and weaknesses inherent in the conduct of foreign economic relations through this overlapping structure of jurisdictional responsibilities?

Many commentators believe that the current division of powers creates serious impediments to the effective management of Canada's external economic affairs.²⁷⁹ Foreign nations may be less willing to

conclude advantageous agreements with Canada if Ottawa cannot provide credible assurances of future compliance. The alternative strategy of seeking unanimous provincial agreement to proposed treaty obligations carries with it the practical result that even one dissenting province may frustrate the conclusion of an arrangement that would confer substantial net benefits on the nation as a whole. This could be a serious problem in future trade negotiations, because the regionally diversified nature of the Canadian economy ensures that provinces will often have conflicting political priorities on commercial policy issues. Moreover, the recent practice of seeking provincial endorsement of proposed trade agreements through non-binding "statements of intention" may not be sufficient to allay the fears of Canada's trading partners in light of the current EEC-Ontario wine-pricing dispute.

Those who argue for an expansion of federal legislative powers to implement foreign economic agreements also stress the strategic reasons for managing trade and investment relations within a constitutional framework that is different from the current scheme of overlapping powers.²⁸⁰ In dealing with foreign nations, questions of timing and bargaining strategy could be crucial to Canada's success in the negotiations. The need to achieve federal-provincial consensus before concluding an agreement could seriously handicap Canadian negotiators by risking disclosure of strategically valuable information or by preventing a swift response to last-minute initiatives. Moreover, Stairs argues that the process of reaching concerted policy positions through confidential federal-provincial negotiations can erode the political accountability on which the parliamentary system is based, since "legislative institutions at both levels of government are merely presented with a *fait accompli*."²⁸¹

Those who oppose any major change in jurisdictional assignments relating to foreign economic policies argue that the benefits derived from preserving provincial autonomy outweigh the costs of jurisdictional conflict and strategic disadvantage. The basic claim is that depriving provincial governments of a more or less co-equal role in implementing trade agreements would bring about an undesirable shift of political power away from regionally based constituencies. In a country in which conflicting economic interests are defined along territorial lines, external trade and investment policies will often result in gains and losses being concentrated on particular regions or provinces. It is argued that the residents of regions which bear a disproportionate share of the burdens from changes in trade policy deserve relatively more influence over such decisions than other national residents do, and that the existing division of powers concerning treaty implementation institutionalizes this conception of political fairness. A high degree of jurisdictional overlap within the sphere of external economic relations protects regional minorities against national majorities by empowering the provinces to deploy policy instruments that can buffer or insulate local communities from the

effects of federal policy initiatives. In other words, if federal tariff cuts disadvantage a local industry, they can be indirectly resisted by means of subsidies, procurement preferences, and protectionist regulations.

This overlapping pattern of jurisdictional responsibilities permits both levels of government to exercise different forms of legal control over the same activities and transactions. For example, the federal government might attempt to implement a treaty banning discrimination in government procurement by enacting legislation that would prohibit the provinces from giving unequal treatment to foreign bidders; or, more likely, by suing to challenge the constitutional authority of provincial governments which persist in granting preferences to local firms. If the courts ruled in favour of Ottawa, the provinces could be required to remove explicit forms of discrimination; but it would be much harder for the courts and Ottawa to police *sub rosa* or implicit favouritism for local suppliers.

Could the federal government legislate a uniform procurement code, with objective criteria for choosing the winning bidder and with highly transparent procedures, and attempt to enforce it against non-complying provinces? Under the existing doctrine of the division of powers, the courts would be likely to hold that the adoption of a detailed code, prescribing the exercise of provincial administrative functions, exceeded the limits of federal authority. This example of how federal and provincial powers overlap in respect to procurement policies can be generalized to most of the other provincial non-tariff measures surveyed earlier. In the case of product standards, for example, the federal government might pass a statute prohibiting discrimination, but it probably could not implement Canada's treaty obligation by homogenizing product standards throughout the country.

Overlapping federalism may prove to be an increasingly costly method of protecting provincial autonomy in a highly competitive world trade environment. Can a nation with a relatively small internal market and a regionally diversified economic structure produce world-class exporters, when the regulatory and promotional policies of one level of government countervail and weaken the policy initiatives of the other? Moreover, provincial resistance to federal initiatives aimed at lowering trade barriers may undermine Canada's bargaining position in future negotiations. If national economic efficiency is impeded by provincial autonomy, competing objectives must be weighed when considering alternative legal mechanisms for promoting intergovernmental cooperation: the maximizing of national income must be weighed against the preservation of provincial control over social and economic changes that impact on local communities. From the standpoint of constitutional design, the critical choice is how national and regional interests will be represented in the body or institution that is charged with weighing and balancing these objectives when conflicts arise between them.

Institutional Choices

We shall conclude by surveying two basic options for institutional reform and comparing them with the constitutional status quo. One possible alternative to the existing system of overlapping responsibilities would be to centralize authority over the implementation of international agreements. A federal treaty power could be linked with more fundamental reforms that would be designed to improve the representation of provincial interests in the parliamentary process; one such reform could be an elected Senate, which would exercise approval powers over legislation enacted by the House. Alternatively, federal treaty power amendment might be adopted without any compensatory reforms aimed at ensuring the provinces some meaningful role in the formulation of foreign economic policies.

The second basic strategy for reform focusses on strengthening existing intergovernmental arrangements to require federal-provincial coordination in the implementation of trade agreements and, in general, in the conduct of external economic relations. The problem of overlapping jurisdictions can be partially resolved by imposing a constitutional requirement that Ottawa and the provinces must take joint decisions when implementing treaties affecting areas of shared responsibility. In order to prevent both levels of government from reneging on such agreements, either directly or indirectly, this reform strategy would also incorporate an enforcement role for the courts, although the scope for judicial intervention would be narrower than under the option involving a federal treaty power. A brief analysis of these two basic options should help to clarify their advantages and disadvantages in comparison with the present legal arrangements.

A FEDERAL TREATY POWER

Federal treaty powers have been included in the Australian and U.S. constitutions, although the specific legal arrangements that have been employed to centralize power over external affairs are dissimilar in the two nations. In many significant respects, the constitutional framework that shapes foreign policy decisions in Australia and the United States represents alternative models, or approaches, to the core problem of all federal states, namely the resolving of conflicts between the regional and national interests which animate the democratic process. In Australia, the power to make and implement treaties is exercised by the federal parliament, a forum in which sparsely populated states have less influence than more populous ones. In the United States, treaties are implemented through ratification by a two-thirds affirmative vote of the Sen-

ate, a body apportioned so that all the states have an equal number of voting representatives.

The U.S. treaty power has not been frequently employed to implement international trade agreements, because the federal legislative power over foreign commerce has been given an expansive interpretation by the courts, and no past administration has negotiated an economic agreement concerning matters that were viewed as arguably within exclusive state jurisdiction. If the U.S. Congress attempted to implement treaty obligations concerning product standards or government procurement practices by enacting legislation designed to override non-conforming state statutes and regulations, it would be likely to succeed on the basis of its authority over international commerce. In the improbable event that a state-initiated constitutional challenge to such federal legislation was sustained, the administration could respond by presenting the agreement to the Senate for ratification as a formal treaty. Therefore, under the U.S. federal scheme, the decision-making process that must be employed to diminish the constitutional authority of the states also operates to augment the influence of regional and local constituencies over the conduct of foreign relations.

Under the Australian scheme, state governments have no constitutional leverage to shape foreign economic policies, and regional interests which would be affected by proposed international agreements must depend on their political influence in the federal cabinet and federal parliament. The federal government's only concession to state government participation in the conduct of foreign relations has been its agreement to consult with the states prior to the conclusion of any significant treaty. The Australian consultation agreement also gives the state governments a first chance to draft and enact the legislation and regulations necessary to implement new treaties. This partial delegation of the central government's treaty power gives state governments some compensating influence over the technical details of implementation and the treaty's overall impact.

The U.S. approach to centralizing control over foreign economic relations has several important advantages over the present Canadian framework, as dictated by the *Labour Conventions* doctrine. First, it limits the scope for overlapping and conflicting policy initiatives, while preserving strong incentives at the federal level to engage state and regional interests in the negotiation and implementation of treaties. The U.S. treaty power displaces state jurisdiction on a constrained, case-by-case basis. Moreover, the prospect of Senate ratification, with the inherent difficulties arising from the need to assemble a two-thirds majority in a body lacking effective party discipline, will often be perceived by the federal administration as a second-best solution to treaty implementation problems. This political disincentive to the invocation of the treaty

power enhances the bargaining leverage of state governments and encourages negotiated solutions to intergovernmental conflicts over foreign economic policies.

A second advantage of the U.S. approach is that it diminishes the role of the courts in determining how power over foreign relations is allocated between the two levels of government. In Canada, the *Labour Conventions* principle of shared responsibility for treaty implementation places great weight on the policy discretion of judges. The past performance of the judiciary in formulating principles for the constitutional division of powers does not inspire confidence that the courts are capable of providing consistent and coherent direction on the allocation of legislative powers over foreign affairs. The U.S. treaty power operates without any direct judicial control over the constitutionally permissible subjects of international agreements, which take precedence over and nullify any non-conforming state law. While the courts do interpret and apply treaties in lawsuits challenging the validity of state laws and regulations, this enforcement role does not confer the broad policy discretion that Canadian (and U.S.) courts exercise in construing the meaning of constitutional provisions.

While the Australian approach to centralizing authority over foreign economic policy eliminates the problems of overlapping legal instruments and conflicting policies, it also deprives the state governments of any effective participation in the decision-making process. In Canada, where many political conflicts over economic policy occur among interest groups that are divided along regional and provincial lines, the transfer of all legislative power over foreign affairs to the federal government would be widely regarded as unfair and a likely source of significant political problems for the government proposing it. In my view, any shift of legislative power to the central government should be accompanied by major institutional reforms, aimed at improving the representation of provincial and local constituencies in the federal legislative process. In any event, any reduction in the existing jurisdictional authority of the provinces will require a constitutional amendment, and obtaining the support of seven provinces for such a change is certain to require some substitute arrangement for giving provincial interests an effective voice in foreign economic policy-making.

One possibility would be to assign a role in the conduct of foreign economic affairs to a reformed Senate, which would be redesigned to provide each province with an equal number of representatives elected at large. An elected Senate could be given the responsibility for approving or ratifying international agreements in advance of their implementation by the federal government. This reform would necessitate the adoption of a constitutional amendment, which would provide that treaties approved by some specified majority of the new Senate would be

self-executing; that is, they would prevail over inconsistent provincial legislation.

LEGALLY BINDING INTERGOVERNMENTAL AGREEMENTS

An alternative to the strategy of a formal centralization of constitutional authority over foreign affairs is to require the two levels of government to take joint decisions on the implementation and, as a practical necessity, on the negotiation of international agreements. A possible design for such a process could require that, before the implementation of any treaty dealing with matters falling within provincial jurisdiction, the federal government would submit the proposed agreement for the approval of an intergovernmental commission or body, composed of one voting representative for each government. A “one government, one vote” rule, specifying a two-thirds majority for approval, would protect provincial interests and at the same time would avoid the problem inherent in the *Labour Conventions* approach, by which one or two dissenting provinces can exercise a practical veto over new international agreements.

The creation of such a federal-provincial body would not involve a sharp break with existing arrangements for intergovernmental cooperation in the field of foreign relations. Informal mechanisms have evolved over the past two decades to facilitate the exchange of information and to coordinate policies that impact on foreign economic relations. During the Tokyo Round negotiations, meetings between federal and provincial officials were convened at regular intervals to discuss bargaining objectives and the specific concessions to trading partners that would be offered to achieve these objectives. However, the concrete results that were obtained through these consultations are not very impressive. The only substantive agreement was the non-binding “statement of intent” on the pricing of liquor and wine — the subject of the EEC’s formal complaint under GATT. Ontario’s administration of its commitment on liquor pricing is not likely to allay the concerns of our trading partners about the value of similar non-binding undertakings in future trade negotiations. The primary advantage of a system of binding federal-provincial agreements will derive from the security of access they would offer our trading partners. Improving the reliability of our trade concessions will increase our bargaining leverage to obtain better access for our exports.

A second advantage of binding intergovernmental agreements, in comparison with the *Labour Conventions* approach, is that they diminish the role of the courts in determining the balance of legislative power between the two levels of government. Binding agreements would entail an interpretive and enforcement function for the courts, but the agreements could be carefully drafted to limit the scope of judicial discretion

to reallocate legislative powers. For example, the present problems of overlapping jurisdictions and countervailing legal instruments could be resolved through prohibitions and quantitative limitations, aimed at specific types of taxes, regulations and subsidies. This strategy for securing federal-provincial policy coordination would eliminate much of the legal uncertainty inherent in the *Labour Conventions* approach, which depends on a case-by-case judicial elaboration of the jurisdictional boundaries.

The main disadvantage of a system of intergovernmental agreements would be its adverse effect on the democratic accountability of the parliamentary system. In my opinion, the problem lies in the monopoly of power held by the cabinet in the Canadian version of parliamentary government. Reforms aimed at decentralizing power in the legislative process, such as stronger standing committees, better access to information concerning the consequences of government policies, and improved research support for the opposition parties, would be the best answer to the accountability problem.

Notes

This paper was completed in November 1985.

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279. See, for example, A. Leal, "Federal State Clauses and the Conventions of the Hague

Conference on Private International Law," Horace E. Read Memorial Lecture, Dalhousie Law School, Halifax, 1983, pp. 20–27; and Hon. P. Martin, *Federalism and International Relations* (Ottawa: Queen's Printer, 1968), pp. 13–19.

280. A good statement of this argument is given in G. Morris, "The Treaty-Making Power: A Canadian Dilemma" (1967), 45 *Can. Bar Rev.* 478, 500–504.
281. D. Stairs, "Foreign Policy," in S. Beck and I. Bernier (eds.) *Canada and the New Constitution* (Montreal: Institute for Research on Public Policy, 1983), vol. 2, p. 165.



Free Trade Continentalism in Canada-U.S. Relations: *Theorization on the Political Dimensions and Outline of an Institutional Framework*

P. SOLDATOS

Foreword

In light of the literature on continentalism and the free trade option in Canada-U.S. relations, and given the Commission's mandate and the various other research projects undertaken under its aegis in this field, we have directed our efforts along paths of investigation of an essentially political and institutional nature. We have done so with three purposes in mind: to suggest a response to the major political and institutional questions raised with respect to free trade by the Commission's mandate; to emphasize analytical aspects hitherto ignored or inadequately explored in the debate; and to promote a more systematic knowledge on these matters through the use of certain theoretical constructs, which we offer as a personal contribution to the study of this subject. We shall, of course, avoid entering the field of investigation of other studies conducted in the context of the Commission's work — studies concerning, in particular, the economic aspects (e.g., the economic advantages and disadvantages of free trade) and specific legal considerations (legal forms of a free trade treaty, compatibility with GATT provisions, and so forth). The purpose of this paper is therefore:

- to highlight the historical and political continuity of the debate on continentalism and free trade, so as to avoid the trap of a general and non-historical analysis, in which the free trade question is viewed in a present-day context, separate from a historical and political background which might elucidate it;
- to emphasize the view of continentalism as a process, so as to draw attention to the integrating trend pushing us toward closer ties with the United States and pushing us to the limits of our free trade options as

Canada undergoes a transgovernmental and transnational integration process;

- to outline the essential dimensions of free trade, stressing in particular the problems involved in the operation of such a regime (origin of goods, distortions, etc.) and its place on an integration continuum, which includes spillover phenomena that could lead to further stages of integration;
- to propose a conceptual framework and classification scheme for tariff and non-tariff barriers, and to relate them to the content of free trade, to the institutional model wherein free trade would be practised, and to corrective policies for irregularities that might arise as a result of the liberalization of trade;
- to suggest a new interpretation of continentalism which does not place decision makers in the diversification-or-continentalism dilemma, and in which a continentalist free trade option could, under certain conditions, be thought of as a springboard to diversification;
- to point out methodological weaknesses in the comparative arguments used to study Canada–U.S. free trade in the light of other experiments in international regional integration;
- to develop a theory concerning spillover effects in Canada–U.S. free trade, using theoretical tools in order to eliminate generalizations, normative statements, and incomplete deductive approaches;
- to examine free trade from a multidisciplinary perspective, combining political aspects and legal-institutional dimensions;
- to provide a critical perspective on free trade, highlighting certain political and institutional disadvantages;
- to view the subject as a multidimensional phenomenon that involves both international integration and foreign policy issues; and
- to provide a synthetic and theoretical view of these problems and interpretations through a number of tables and figures.

Among the various contributions proposed by our study, the following appear to us to be new and more theoretical than other work done in the field: our concept of continentalism, developed in correlation with the notion of diversification; our contribution to the study of the institutional question in Canada–U.S. free trade (i.e., the principle of proportionality and our proposed institutions for the free trade area); our conceptualization of tariff and non-tariff barriers, along with references to the law and to the jurisprudence of the Court of Justice of the European Communities (EC); our theoretical view of possible spillover effects from a Canada–U.S. free trade area which might lead to a higher degree of economic and political integration; our many tables and figures, explanatory and analytical in nature; and our broader view of the issue, in which the question of free trade is placed at the core of Canadian foreign policy.

Introduction: Continentalism and its Free Trade Dimension

This introduction contains a number of sections. Continuing along the lines described in the Foreword, we pursue five major objectives: to define the subject of the study; to highlight its historical and political background, as well as the major causes of Canadian fears about the free trade option; to explain the reasons for the renewed debate over this issue; to indicate the principal weaknesses of political-institutional analyses of free trade continentalism; and to outline a plan for the various levels of analysis that will be developed in this paper.

The General Question of Free Trade Continentalism

Without anticipating the systematic conceptual framework that will be developed in the next section of this paper, we can give a preliminary definition of this issue, as follows. Continentalism is a process of international regional integration which is part of the greater transnational reality of Canada-U.S. relations (e.g., partial and on-going integration involving multinational firms, economic and bureaucratic elites, union groups, business transactions and social communications in general, factors of production, life-styles, sociocultural values, and so on). However, there are some who would wish to formalize and consolidate part of these relations through a free trade agreement between the two countries that would stand at the lower end of the integration continuum of the various institutionalized forms of international regional integration.

Free trade continentalism has historically reflected a foreign policy philosophy which various actors, at different times in the history of Confederation, have desired to transform into a fundamental option and into an implementation project in Canada's foreign policy.¹ This philosophy was into practice for several years in the mid 19th century through the Reciprocity Treaty, and it had limited sectoral application following World War II; proponents of this idea of free trade are now attempting to include it as one of our basic foreign policy options. Eliminated as such an option in 1972,² free trade continentalism once again surfaced in 1983,³ and during the 1980s it should remain the central focus of discussions on the orientation of Canada's foreign policy and on domestic policies of internal economic restructuring.

To explain these dimensions in terms of foreign policy, we have prepared Table 2-1, in which free trade continentalism is inserted in a typology of the various dimensions of Canadian foreign policy in the 1970s and 1980s.

Historical and Political Continuity⁴

Long before Confederation, the free trade issue was at the heart of the debate over a framework for Canada-U.S. relations; since that time, it

has become one of Canada's main concerns. As a vital part of our foreign policy, free trade is extremely important for our domestic life, since the scope of its impact on Canada's economic, sociocultural and, more generally, political character cannot be denied.

First implemented, although only partially, through the Reciprocity Treaty of 1854, the free trade option has, since the last century, been painted in glowing colours by a number of Canadians because of its numerous, mainly economic, benefits; but it has been rejected by others, who have seen it as the beginning of a process of assimilation into the vast American system. The historical and political base of this continentalist debate can be seen from the names of those associated with it: Macdonald, Mackenzie, Laurier, and Borden, among others.

The Manichean approach of the free trade option has, however, often obscured and politicized discussion about its real merits and weaknesses. For example, we have never been able to examine the option of closer economic ties through free trade in a purely economic perspective. Social, cultural, and political considerations have always intervened as basic orientation and decision variables.

From Canada's point of view, the reasons for the multifaceted nature of the debate are clear, residing as they do in the many fears and uncertainties which such discussions foster. The debate has been made more complex by the specific characteristics of Canada's historical and political origins, by its geographic position, socioeconomic structure, culture, and political life. This is only to be expected. Throughout its history, Canada has been unable to approach the debate over Canada-U.S. free trade in any clear, consistent manner.

Born of colonial determinism, Canada was from the outset torn between different and contradictory systems of political values. The republican spirit, the conservatism of the Empire, and nationalist ideology all exercised their attractions on various segments of Canadian society. Having no other option for international regional integration than that of an assimilative partnership with the United States, Canada hesitated between the rationality of economic development and the aspiration of achieving autonomy. Canadian leaders were uncertain about the effects of the relational and structural differences in size between the two partners in the free trade adventure; also, they wished to reconcile three disparate elements: Canada's subcontinental affiliations, its connections to the British Empire (later the Commonwealth), and the philosophy of diversification, often on a worldwide scale. In addition, Canada was divided over the question of spillover effects from free trade and the possibility of their leading to other stages of economic integration — even to political integration. The situation was further complicated by internal political fragmentation,⁵ a fragmentation arising from such factors as the federal nature of the system, with its various levels of government; the institutional and bureaucratic overlapping of

TABLE 2-1 Canada-U.S. Free Trade Continentalism: Its Conceptual, Explanatory, and Operational Insertion in Canadian Foreign Policy

I Environment	II Major National Goals (1970 White Paper)	III Major National Objectives (1970 White Paper)	IV Policy Options Related to Major National Objectives (1972 Document)	V Meanings of Continentalism
Internal environment (political, strategic and military, economic, cultural)	Canada must safeguard its political independence	Stimulate economic growth in Canada	First Option (rejected) Canada may seek to maintain its relations with the United States in more or less their current state, modifying its policies as little as possible	Process of regional integration
External environment (political, strategic and military, economic, cultural)	Canada and all Canadians must enjoy general and increasing prosperity	Promote social justice Improve the quality of life	Second Option (rejected) Canada may move deliberately toward greater integration with the United States (continentalism).	Foreign policy philosophy
Regional (American sub-continent)	All Canadians must find values worth preserving and fostering in their lives and relations with other people	Preserve Canada's sovereignty and independence	Third Option (adopted) Canada may adopt a general, long-term strategy to develop and strengthen its economy and other aspects of its national life, thus reducing Canada's current vulnerability.	Basic orientation in foreign policy
Global (global international system and sub-systems)	Work for peace and security	Maintain harmony in the natural environment		

TABLE 2-1 (cont'd)

VI Determining Factors in the Current Renewed Debate Surrounding Free Trade Continentalism (examples)	VII Sectorial and Intersectorial Options for Implementing Continentalism (examples)	VIII Approaches (Successive or Simultaneous) to International Interaction in Favour of Continentalism (examples)	IX Obstacles to Free Trade Continentalism (examples)
Tariff liberalization within GATT	Second Option (economic continentalism)	Bilateralism selective asymmetrical institutionalized	Fear of increased dependence
Existence of an advance process of transnational and infrastructural continentalism in Canada-U.S. relations	Canada-U.S. free trade agreement (general or sectoral)	Regionalism (selective)	Fear of economic, political and cultural spillover
Existence of a regional form of continentalism (transborder or transregional)	World Product Mandates	Transnationalism “Staticization”	Opposition by some political and bureaucratic elites, intellectuals, and certain segments of public opinion in Canada
Canadian need to remove American non-tariff barriers (certain GATT weaknesses in this area)	Reorganization of the Canadian economy and cultural and institutional strengthening (to compensate for continentalist economic integration)	Federal centralization	Uncertainty about how the option will be welcomed by American elites
Difficulties in the process of implementing Canadian diversification policies	Socioeconomic cooperation “Quiet” diplomacy and public diplomacy	Redeployment of the Canadian economy in North America and the rest of the world	Fear of strengthening in regional protectionist blocks

State of public opinion and of that of Canadian elites	Options already eliminated by the Canadian side	Fear of reaction by other industrialized countries
Needs involved in the Canadian economy reorganization process	Canada-U.S.-Mexico common energy market	Expected difficulties involved in negotiating free trade
Possibility of using continentalism as a springboard to diversification	Common market (bilateral or trilateral with Mexico)	Inadequacy of free trade (formula for so-called negative integration)
	Economic union	
Experiments in sectoral Canada-U.S. free trade		
International ideological and diplomatic-strategic polarization		
Certain American difficulties on the world scene (economic, political, etc.)		

functions; geographical divisions; fragmented economic realities; and the still incomplete nature of the nation-building process.

In addition to these problems, real or perceived, and to these fears and uncertainties, there have been inherent weaknesses of approach in Canadians' scientific understanding of the results of the free trade process. This situation has arisen for the following reasons. The economic consequences of free trade will be unevenly distributed over the various segments of Canadian society; the sociocultural and political impact of free trade does not lend itself easily to quantification and cannot be measured with highly rigorous methodology; free trade's processlike character does not enable us to perceive all the variables of the related integration phenomenon; the stages in its implementation through time remain unclear; the process of its negotiation cannot be simulated accurately; and the American positions concerning principle and content are not well known.

The Need to Identify Reasons for the Renewed Debate

Our purpose in explaining the reasons for the renewed debate on free trade continentalism is a policy-oriented one: to emphasize the determining weight of a series of integration variables which place free trade within the context of an integration process that is already underway and is already developed to a large extent, particularly in the area of transnational Canada-U.S. relations.

The continentalism question has never completely disappeared from the Canadian debate (as an option or as a danger, depending on the period and the party concerned), and it was reinserted in the Canadian foreign policy review process in the early 1970s. In 1972 it was quickly rejected by our decision makers — more for reasons of political and cultural protectionism, and of nationalism originating in Ottawa, than through any careful examination of the economic reasons, in favour of a policy of diversification, the cornerstone of the 1972 Third Option. Since then, it has often reappeared in various proposals from both sides of the border, suggesting closer ties between Canada and the United States through such means as greater cooperation, a general or energy common market, a free trade defined in various ways, and, to a marginal extent, an economic union.⁶ Lastly, Canadian free trade proposals formulated in recent years⁷ have renewed the continentalism debate by providing more specific implementation perspectives.⁸

We have examined the free trade debate in this context of renewal, and without claiming to provide an exhaustive list, we would suggest the following as reasons for this resurgence of continentalist ideas:

- Tariff liberalization measures, implemented or planned during the 1980s, through negotiations within GATT, have submitted a large

proportion of Canada-U.S. trade to a process of tariff liberalization, thus creating major conditions of continentalism.

- The existence, despite our efforts at diversification in the 1970s, of a very high volume of trade with the United States, the development of intrafirm trade, and the maintenance of a high level of American ownership and control in key sectors of the Canadian economy are contributing factors to a relational and structural form of transnational economic continentalism.
- Difficulties encountered within GATT in reducing and eliminating non-tariff barriers, accompanied by the resurgence, caused by the crisis, of a new protectionism (through legislation and policies) in the United States, have encouraged Canada to seek bilateral dialogue with the United States in the hope of protecting the Canadian economy from American non-tariff measures, both present and future, through free trade agreements which would include coverage of non-tariff barriers.
- Obstacles to implementation of the Third Option, as well as the meagre results of our current efforts at diversification outside the continent, are reviving continentalist theses.
- Canada is being pushed into closer ties with the United States by the crisis in the economies of our partners in the industrialized world, especially in Europe, and by the massive debt of Third World and Eastern countries, by the crisis in East-West relations, by Japanese protectionism, and by European policies that do not always meet our requirement for diversification (e.g., European strategies concerning investment in Canada).
- The pressures brought to bear by various Canadian elites (private sector, Senate, bureaucratic elites, and so forth) in favour of the Second Option (continentalism), particularly in view of the record of the Third Option (diversification) and its future prospects, are strengthening the pro-continentalist lobby in Canada.
- A certain "softening" of public opinion in recent years in favour of the idea of closer Canada-U.S. ties is facilitating the promotion of continentalist theses.
- The need to restructure the Canadian economy significantly, in order to enable Canada to remain an advanced industrial society, is leading a number of political and economic elite groups in Canada to seek American support for a more integrated subcontinental economy, in order to achieve modernization, specialization, economies of scale, etc.
- The idea that continentalism not only is not the opposite of diversification but that it may actually serve as a springboard to diversification has made progressive headway in recent years.
- The reorganization, whereby the institutional component of foreign trade was added to the Department of External Affairs, has strengthened the lobby within the department that is in favour of the Second Option (continentalism).

- The development of transborder or transregional forms of continentalism, wherein the Canadian provinces are subsumed under economic development areas comprising numerous American states, is creating favourable conditions for an overall movement toward closer economic ties that may be extended to both countries as a whole and formalized by an agreement between the two federal governments.
- The existence of a certain amount of sectoral free trade, bringing the two economies together (automobile market, production of defence material, etc.), is reinforcing this pro-integration trend.
- The increased ideological and diplomatic-strategic polarization that characterizes current East-West relations is bringing pressure to bear on Canada to show Western solidarity and discipline with respect to (and under the leadership of) the United States, which expects its allies, in particular the one in North America, to close ranks. Consequently, an effort at cooperating with Eastern communist countries and with certain Third World countries of anti-American persuasion could be considered by the United States to be inconsistent with its containment policy; and, particularly since the Reagan administration came to power, with its partial “roll-back” policy (e.g., President Reagan’s desire for a more liberal attitude to trade unions in Poland). Indications of this rigid American approach, with strong undertones of Western solidarity, were provided during the debate over construction of the Soviet pipeline. They have also been evident at recent summits of industrialized countries concerned with certain monetary policies and East-West trade. Despite signs of improvement in East-West relations, the return to a true détente seems unlikely at present.
- This diplomatic-strategic context, the economic crisis, and the antagonistic nature of relations between the Western economic powers could compromise the realization of one of the conditions for implementation of the Canadian diversification policy, namely a general understanding that the impact of the Third Option should be “easy to absorb (by the Americans) at a time of general growth and prosperity.”

Weaknesses in Political-Institutional Approaches

Despite the efforts of economists who, although far from unanimous in their conclusions, have striven, through quantitative and qualitative methods, to determine the advantages and disadvantages for Canada of free trade with the United States, the political-institutional approach to the question remains vague and fragmentary.

Since the principal method of investigation used in this type of work is comparative analysis, authors have often looked to the free trade experiments of other industrial societies, such as those of the European Free

Trade Association (EFTA), the New Zealand–Australia Free Trade Area (NAFTA), and the England–Ireland free trade area. In these experiments, they have sought comparative information on ways of implementing free trade regimes, as well as information on content, institutional frameworks, and the effects of free trade (the spillover question). However, there can be no comparative analysis without a methodology for comparison and for careful examination. References made to international integration experiences are very general in nature. Consequently, their conclusions are impressionistic, fragmentary, and highly uncertain. Furthermore, the conclusions are not supported by economic history or theory in any way that might reveal how the free trade areas have evolved through time, through space, and along the continuum of forms of international regional integration.

For this reason, we have directed our inquiry along five major lines of investigation, which will be taken up in the next five sections of this paper. The areas to be dealt with are as follows: continentalism in Canada–U.S. relations; free trade areas, their content and weaknesses; the institutional question; the search for a comparative paradigm to understanding; and the spillover hypothesis.

Conceptualization of Continentalism in Canada–U.S. Relations

Before beginning our examination, we should give a definition of the term “continentalism.” This is necessary for several reasons. First, it will enable us to underscore the concept’s multidimensional aspects, thus reducing the risks of simplification to which decision makers are open. We shall note, for example, that plans to establish an intergovernmental framework for cooperation or institutionalized integration under a free trade regime is not the first stage of continentalism, since transnational interpenetration in Canada–U.S. relations has already set a continentalist integration process in motion. We shall also be aware of the broad range of possible forms of institutionalized continentalism, corresponding to those of international regional integration. The free trade area is only one of these forms, and it may even become the initial stage in a succession along a dynamic integration continuum. Secondly, such a definition will afford us the opportunity to seek out the concept’s historical and political roots. Lastly, it will help us to highlight the conceptual environment of continentalism by clarifying the relationship between continentalism and diversification, a relationship which, contrary to the generally accepted interpretation that the two concepts are contradictory, may in fact, according to some, be one of compatibility and even complementarity.

Meanings, Levels, and Dimensions of Free Trade Continentalism

MEANINGS

The major meanings of the concept of continentalism are as follows: a phenomenon of international regional integration; a foreign policy philosophy; a basic foreign policy orientation; and an option and set of specific foreign policies for continental integration.

As a phenomenon of international regional integration, the concept of continentalism, in the context of Canada–U.S. relations, means a process of microregional (i.e., subcontinental) integration. This has already begun at the level of transnational relations (e.g., multinational corporations, unions, economic elites, etc.); at the level of transgovernmental relations (e.g., Canadian provinces and American states); through transregional or transborder relations which have led to closer transactional ties (e.g., diplomatic, administrative, commercial, cultural, communicational, etc.); and through structural interpenetration, particularly economic. Yet this has produced very little in the way of intergovernmental institutionalization (e.g., sectoral free trade, such as the Autopact), and pressure is being exerted for these relations to have a broader base, particularly through general free trade.

In its second meaning, as a philosophy of foreign policy, continentalism postulates the usefulness of closer ties between Canada and the United States and of preferential integration links at the subcontinental level. Restricted to this level, continentalism remains an ideological variable in the foreign policy debate.

As a basic foreign policy orientation,⁹ the concept of continentalism refers to an intermediate variable between the determining factors and the choices of Canadian foreign policy, indicating how this policy will probably be oriented (in this instance, toward a preference for subcontinental integration). In this sense, continentalism has not yet become a basic orientation in Canadian foreign policy.

In its fourth meaning, continentalism is an option and set of concrete implementation policies for an integration at the subcontinental level. An example of this is the Canadian government's Section Option and its sectoral free trade policies, implemented or proposed.

LEVELS

The main possible or existing levels of continentalism include the following: overall continentalism (involving the entire socioeconomic and political territory of the two countries) and regional, transborder or transregional continentalism (concerning American and Canadian regions which are near one another, or which border on one another, in a

microregional perspective); generalized continentalism (integrating all areas of systemic activity) and sectoral continentalism (integrating one or more limited sectors or subsectors of systemic activity); intergovernmental continentalism (integration at the central government level), transgovernmental continentalism (involving the relations of the government representatives of American states and Canadian provinces, either among one another or with transnational actors, and with representatives of the other central government) and transnational continentalism (integration with respect to transnational actors); transactional or relational continentalism (with respect to transactions) and structural continentalism (concerning structures, in particular economic structures); institutionalized continentalism and non-institutionalized continentalism (the first being sanctioned by agreement and perhaps embodied in institutions, the second representing a *de facto* integration process, particularly through transnational relations); perfect continentalism (total integration as in, for example, total economic integration) and imperfect continentalism (free trade areas, for example); negative continentalism (suppression of barriers, e.g., trade barriers) and positive continentalism (e.g., formulation of common policies); immediate continentalism (immediate creation of an integration framework) and progressive or step-by-step continentalism (progressive elimination of obstacles and gradual formulation of common policies, etc.); static continentalism (integration restricted to its initial forms) and dynamic continentalism (which starts a spillover process).

DIMENSIONS

Lastly, in the category of dimensions of continentalism are socioeconomic continentalism, cultural continentalism, communications continentalism, administrative continentalism, military continentalism, and political continentalism; the first five of these are already an integral part of the contemporary reality (institutionalized or non-institutionalized, governmental or transnational) of Canada–U.S. relations.¹⁰

The various facets of the concept of continentalism are summarized in Table 2-2. Free trade is shown in the table as a continentalist foreign policy option and as a concrete policy for implementing continentalism, to which it may impart a form of continentalism that is economic (either global, general, or sectoral), intergovernmental, initially relational, institutionalized, imperfect, negative, progressive, and dynamic. It is clear that this concept applies more to Canada, since the United States is not sufficiently involved in the debate. This does not mean, however, that there is no interest in the subject in the United States. One can think of notable examples, such as the Senate Foreign Relations Committee's subcommittee on international trade, the national governors' association, a number of oil lobbies, and the opinions expressed by such leaders

TABLE 2-2 Major Conceptual Facets of Continentalism in the Context of Canada-U.S. Relations

I Meanings	II Levels	III Dimensions
Process of international regional integration in North America	Overall and regional (transborder and transregional) continentalism	Socioeconomic continentalism
Foreign policy philosophy	Generalized continentalism, general continentalism and sectoral continentalism	Cultural continentalism
Basic foreign policy orientation	Intergovernmental continentalism,	Communications continentalism
Foreign policy option and set of concrete implementation policies	transgovernmental continentalism, and transnational continentalism	Administrative continentalism
	Transactional or relational continentalism and structural continentalism	Military continentalism
	Institutionalized continentalism and non-institutionalized continentalism	Political continentalism
	Perfect continentalism and imperfect continentalism	
	Negative continentalism and positive continentalism	
	Immediate continentalism and progressive continentalism	
	Static continentalism and dynamic continentalism	

as President Ronald Reagan, Senator Edward Kennedy, and former Undersecretary of State George Ball.

Continentalism and Diversification: Contradictory or Compatible?

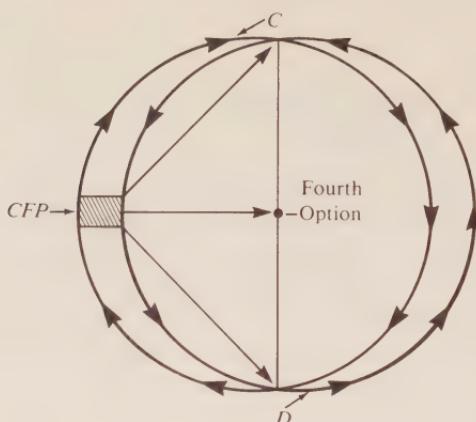
Throughout the political and historical development of our foreign policy, continentalism has been seen as an alternative — desired or imposed — to diversified, extracontinental relations that have become difficult or less attractive. (In this case, diversification indicates a policy of seeking to provide the country with a large number of partners and a set of relationships of quantitative and qualitative importance.) Continentalist policies have, however, been only partial in nature, since Canada has not wished to turn its back to opportunities for diversification in order to accept an exclusive continentalist relationship that would become too assimilating.

Nevertheless, a clear distinction has generally been drawn in the specialized literature and in the discourse of decision makers between continentalist policies and diversification policies, while not enough attention has been paid to areas where the two types currently overlap and interact. Today, however, the very high degree of transnationalism in foreign relations has resulted in a situation where, under certain conditions, continentalism is beginning to appear as a springboard to diversification and vice versa.¹¹

Some observers are beginning to think that there are areas where, in certain circumstances (for example, the adoption of a true world product mandates formula),¹² greater Canada-U.S. cooperation, perhaps even integration, in such areas as specialization, modernization, technology transfers, etc., would strengthen the Canadian economy in its attempts to penetrate the markets of other countries and to re-deploy Canadian capital on a broader international basis through continentalist alliances with American capital. Also, one should not overlook the fact that certain diversification operations, particularly through transnational cooperation, could reinforce the Canadian economy and increase its weight in the Canada-U.S. continentalist relationship; such operations could give Canada and its partners in diversification a stronger presence on the American subcontinent.

In the multinational and transnationalized interpenetration of capital, Canadian capital cannot always be clearly identified under either diversification or continentalism. As a result of transnational alliances, we may find (in the United States under continentalism and in other partners under diversification) a capital that is usually international in nature. European capital,¹³ for example, may find its way into North America through Canada's diversification policy; or, where it is already

FIGURE 2-1 Relationship Between Continentalism and Diversification



Legend: CFP Canadian foreign policy
C Continentalism
D Diversification

present, it may place Canada in a continentalist context. On the other hand, Canadian capital may be internationally channelled through continentalist alliances with American capital in order to broaden the scope of Canadian diversification.

Finally, the government publications *A Review of Canadian Trade Policy* (1983) and *A New Direction for Canada* (1984) are moving in the direction of compatibility between the Second Option and the Third Option. Figure 2-1 illustrates this concept of compatibility between continentalism and diversification. In the language of Canadian foreign policy in the 1970s, this could be called a Fourth Option, which combines the three options of Mitchell Sharp's 1972 document, particularly the second and third.

In Figure 2-1, the diameter and the direction of the arrows indicate a cyclical relationship and synthesis between the options of continentalism and diversification, such that the adoption of one option is a springboard to the other. This accords with the explanation of this relationship that was given earlier in this section. According to the arrows, one passes from continentalism to diversification, and vice versa, since the concentric circles of continentalism (C) and diversification (D) have points of intersection.

There are, however, a number of drawbacks to this Fourth Option:

- It could mortgage the credibility of our diversification policy vis-à-vis our extracontinental partners, such as Europe and Japan, as well as vis-à-vis the various segments of Canadian society (e.g., the public sector, the private sector, academic circles, and the mass media), creating doubts as to our willingness to diversify.

- It would reinforce the effects of the Second Option rather than those of the Third Option, because of the current importance of the transnational and transregional continental reality, and thus it would not be able to maintain the equilibrium between the two.
- All diversification that might result from the Fourth Option would be closer to diversification in the context of a North American economy (of Canada and the United States) than of a Canadian economy that wished to differentiate itself from that of the United States.

To sum up, starting from a Fourth Option, the shift toward some Second Option effects would, in large part, bring the debate on the Fourth Option back to the continentalist reality, with its advantages and disadvantages.

Free Trade Areas: Their Content and Weaknesses in the Context of a Canada–U.S. Agreement

Definition of a Free Trade Area

A free trade area is the economic zone within which two or more countries have decided to permit the free movement of goods originating in the area, by removing tariff and non-tariff barriers (negative integration).¹⁴ Each of the partners maintains, however, its own external tariff and non-tariff policies with respect to third countries.

The free trade area may take several forms, and it is situated on an integration continuum comprising a number of phases of international regional economic cooperation and integration. These forms and phases are outlined in Tables 2-3 and 2-4.

We find four key concepts in the definition of free trade: goods, goods originating in the zone, tariff barriers, and non-tariff barriers. These concepts need to be defined to specify the ideas relating to Canada–U.S. free trade. This is particularly important because the Canadian literature

TABLE 2-3 Principal Forms of Free Trade Areas

Multilateral, bilateral or unilateral
Global or regional
Perfect (removal of all barriers) or imperfect
Generalized, broad or sectoral
Automatic or negotiated (at each stage of the removal of customs barriers)
Immediate or gradual
Closed or evolutionary
With total or partial reciprocity
Symmetrical or asymmetrical (weight of partners)
Institutionalized to a greater or lesser degree

TABLE 2-4 Phases of Regional-International Economic Integration ("Ideal Type")

Cooperation and Integration Measures	Types of Cooperation and Integration					Partial or Total Economic Union ^a
	Cooperation Association	Free Trade Area	Customs Union	Common Market	Monetary Union ^a	
Economic concertation	X	X	X	X	X	X
Elimination of tariff and non-tariff barriers		X	X	X	X	X
Common external tariff (with, eventually, a certain harmonization of economic policies — perhaps trade policies)			X	X	X	X
Free movement of goods, persons, services and capital				X	X	X
Common currency and/or monetary policy					X	X
Common economic policies					X	X

a. Although, in an "ideal type" integration, each integration involves prior steps, it can happen that a monetary or economic union does not include all the prior integrative steps.

on this topic and the related official documents most often take an economic or political approach, without delving into the legal and institutional aspects of a free trade zone.

The Concept of Goods

The meaning of the term “goods”¹⁵ might be considered obvious at first glance, yet the term has been known to give rise to problems of interpretation in the application of a free trade system. It therefore requires definition as a legal concept.

The jurisprudence of the EC Court of Justice proposes¹⁶ a very relevant definition. It considers as goods “any product having a monetary value and that can be the object of a commercial transaction.” Thus, according to the court, even art objects or objects of historical interest constitute freely traded goods when an export tax, calculated on the basis of their value, is imposed, thereby confirming their commercial character. To give a second example, this is also the case with old coins for sale; they represent goods rather than capital.

Problems Concerning the Origin of Goods

The notion of goods originating within the zone is of major importance in a free trade area which is not also a customs union, since only the products of the zone circulate freely, while the products coming from other countries remain subject to the tariff and non-tariff restrictions of each partner. Identifying the origin of goods can be particularly difficult in the case of manufactured products, which go through various stages of processing both in and outside the area. The definition of origin adopted in free trade areas is based on the notion of added value; for a product to be considered as originating in the area, a certain percentage of its value must be added during its processing within the area. This percentage is usually over 50 percent.

For certain specific cases of customs regulation, EC Regulation 802/68 provides a definition that can help to identify the origin of goods without stating a particular percentage of added value:

A product is considered as originating in a given country if it has been entirely obtained or produced in that country. Goods with which two or more countries are concerned are considered as originating in the country in which the last economically justifiable transformation process took place, on condition that such an operation was able to be conducted by a firm equipped for that purpose and that it has resulted in the manufacture of a new product or represents a major stage in the product's manufacture.
(translation)

The value-added percentage varies according to the objectives of the partners. A large percentage is set when the partners wish to prevent the free movement, in their free trade area, of a third country's products which have undergone little processing in the area (for example, goods that require only assembly or packaging, or semimanufactured products that need little processing). Such a practice prevents the diversion of commercial traffic. However, if a high percentage is set in an area that includes both Third World and industrialized countries, this can hinder the light processing activities to which Third World countries are restricted given their low level of industrial development. (Third World countries often take part in the international division of labour through assembly or packaging activities. Consider, for example, the case of the Lomé Convention.)

Under a Canada-U.S. free trade regime, the value-added percentage should fall within the approximate range of 50 to 75 percent, since both countries, but particularly Canada, have a stake in preventing the in-transit goods of other newly industrialized or industrialized countries from halting the creation of trade within the area; both Canada and the United States wish to avoid allowing others to benefit from the liberalization, thus causing trade diversions. (This could happen if goods, which are highly competitive because of their high quality or their low cost of production, are shipped through the country that has the lowest customs tariff.) As in similar instances of free trade, the setting of a value-added percentage will be subject to a complex bargaining process based on the types of products concerned and the sectors to be protected in each country. Lists of products with differentiated value-added rates could be appended to the text of the free trade treaty.

As regards the mechanisms for controlling origin, certificates of origin must be used. This will, of course, make for higher costs and for more administrative complexities and red tape. The length of the Canada-U.S. border and the volume and scope of the two partners' foreign trade would require administrative controls that are far more complex than the current customs controls.

Determining the origin of goods and trade distortions is a highly complex matter which should be subject to systematic analysis. The legal approach to free trade has already yielded a number of rigorous studies on these questions. Since these studies are known to the experts in the field, we need not clutter our text with details on the terms and conditions under which countries must comply with regulations concerning origin or on the enforcement of regulations whose purpose is to avoid trade distortions. The highly detailed study by J. Labrinidis, *The Structure, Function and Law of a Free Trade Area: The European Free Trade Association* (London: Stevens and Sons, 1965), deals at length with the technical side of the problem of origin.

Tariff Barriers

Contrary to the distinction drawn in the literature between tariff barriers and non-tariff barriers, we shall here make use of the fourfold classification provided in the EC treaty: customs duties; taxes equivalent in their effects to customs duties; quantitative restrictions; measures equivalent in their effects to quantitative restrictions. Non-tariff barriers fall into the last two categories, even though the literature and legislation in some cases include, under non-tariff barriers, certain taxes that are equivalent in their effects to customs duties.

CUSTOMS DUTIES AND OTHER TAXES

In general, and for the purposes of a Canada–U.S. free trade area, customs duties are considered as the major type of tariff barrier. The establishment of a real free trade regime should provide for the abolition of customs duties, as well as the abolition of a complex range of other tariff barriers, which the EC treaty refers to as “taxes equivalent in their effects to customs duties” and which the EC Court of Justice has attempted to classify, revealing a major group of taxes that are sometimes difficult to distinguish from domestic taxes.

TAXES EQUIVALENT IN THEIR EFFECTS TO CUSTOMS DUTIES

Since the implementation of a Canada–U.S. free trade regime could be hindered by such taxes, which might be levied either at the time the goods cross the border or later (a fact that complicates matters), we shall introduce this range of taxes in the light of EC jurisprudence. This will provide those drawing up a Canada–U.S. free trade agreement and the institutions responsible for its implementation with a frame of reference that will enable them to understand the situation.

In its definition, the EC Court of Justice first based its concept of a “tax equivalent in its effects” on criteria of discrimination with respect to similar domestic products. It ruled that this tax was a unilateral duty, imposed either at the time of importation, or after importation, and that, in affecting a product specifically imported from a member country to the exclusion of a similar domestic product, it had, by altering the price, the same effect on the free movement of goods as a customs duty.¹⁷

In a subsequent case, using the criteria of substance rather than form, the court extended the notion of a “tax equivalent in its effects” to forms of non-discriminatory taxation that are not related to competition and are imposed when goods cross a border. This broadened concept included:

Any monetary charge, however small, which is imposed unilaterally on domestic goods (in the case of exports) or on foreign goods, because they have crossed a national border, and which is not a customs duty as such but constitutes a charge that is “equivalent in its effects,” as provided under Acts 9 and 12 of the Treaty, regardless of its denomination or form, even if the revenue does not accrue to the state or does not have any discriminatory or protectionist effects, and even if the product thus taxed is not in competition with domestic national products.¹⁸ (translation)

At a later date, the court broadened this notion further to include cases falling within the framework of a domestic taxation system that applies to both imported and domestic products. The court ruled that “a duty levied systematically within the framework of the overall domestic taxation system on national and imported products, in accordance with the same criteria, may nevertheless constitute a tax equivalent in its effects to a customs duty on imports, where the purpose of such a tax is to support activities that specifically benefit the domestic goods taxed”¹⁹ or benefit the state imposing the tax and its nationals.

The court even included in this category charges that are imposed unilaterally for services rendered when goods cross the border, where such charges exceed the cost of the service or do not benefit “immediately and individually” those for whom the services are intended. (This is true, for example, if the services rendered benefit the entire population, as with charges for public sanitation control measures, or if they benefit a specific category of persons, as with charges levied for the collection, at the border, of statistical data which might benefit a group of exporters.)²⁰

Non-Tariff Barriers²¹

Non-tariff barriers (or measures, since they may include distortions that stimulate trade to some extent) pose much greater problems of definition and identification than taxes that are equivalent in their effects to customs duties. The literature and documentation on Canada–U.S. free trade refers insufficiently to non-tariff barriers, a fact that prevents us from establishing conceptually and empirically the scope of the required liberalization process. In this connection, EC law and jurisprudence, the Canadian Senate, and GATT have adopted terminology and proposed categories for non-tariff barriers; these will enable us to define a number of aspects of the protectionist shell which the implementation of a Canada–U.S. free trade area should attack. In the EC’s terminology, we shall speak of “quantitative restrictions,” which are easy to define, and “measures equivalent in their effects to quantitative restrictions,” which are far more numerous and more varied in nature.

QUANTITATIVE RESTRICTIONS

According to the EC Court of Justice, quantitative restrictions are measures that lead to "a total or partial halt in imports or exports."²² In the case of partial limitations, they may be defined as "restrictions imposed on a product in terms of volume or value." Quotas on international trade are the most common form of quantitative restriction.

MEASURES EQUIVALENT IN THEIR EFFECTS TO QUANTITATIVE RESTRICTIONS

The matter of measures equivalent in their effects to quantitative restrictions is more complex and more difficult to define. For this reason, the EC Court of Justice has as yet been unable, through its jurisprudence, to make a complete inventory of them. Existing free trade areas continue to discover such measures; GATT has only partly defined them; and Canada's Senate standing committee on foreign affairs, like the literature and documentation on Canada-U.S. foreign trade, refers only vaguely to them. It is thus difficult to gain a thorough understanding of their scope and complexity.

We must, however, discuss these measures for two reasons: to demonstrate the scope of the liberalization process that must be undertaken; and to reveal the need for joint institutions which are strong enough to ensure that established regulations are respected and strong enough to identify new non-tariff barriers. These institutions need to be much more important than the framework planned for the Canada-U.S. free trade area. (Witness the case of the EC, in which the Court of Justice is attacking the matter of non-tariff barriers very effectively.) Non-tariff barriers are like the Hydra of Greek mythology, whose many heads, when cut off, merely grew again.

EC law²³ has defined a number of specific types of measure that are equivalent in their effects to quantitative restrictions. These include the following: import or export conditions other than formal requirements, which are extended by the Court of Justice to include certain formal requirements such as import or export permits, even if these are granted automatically; measures which, while applying to both foreign and domestic products, in practice affect foreign products to a greater degree (for example, product form, size, weight, and identification standards that are respected in country A but must be enforced on the products of country B, which does not require them, for export to country A), particularly where the purpose of these measures could be achieved through softer restrictions.

To these, the EC Court of Justice has added measures that are equivalent in their effects to quantitative restrictions. These include the

following: measures drawing a formal distinction between intrastate and intra-area trade (e.g., measures preventing wine producers of other member countries from using certain brand names that are reserved for domestic wines);²⁴ measures establishing a material difference between intrastate and intra-area trade (e.g., measures that, while intended to apply to both domestic and foreign products, affect the latter to a greater extent);²⁵ measures that fragment the channels of intra-area trade (e.g., Belgium's requirement that importers produce a certificate of origin issued by British producers of Scotch whisky for the Belgian importers, thus preventing illegally, according to the court, imports from being shipped to Belgium through French distributors);²⁶ restrictions that are inherent in the existence of state trade monopolies and in state-controlled markets.²⁷

To these measures may be added certain non-tariff barriers listed by Canada's Senate standing committee on foreign affairs.²⁸ These include grants to enable certain domestic producers to defend themselves against competition or to export their products; compensation duties (which we prefer to place in the category of "taxes equivalent in their effects to customs duties"); certain tax abatements and other fiscal incentives; legislation favouring the purchase of domestic products; customs evaluation regulations; various technical, quality, safety, and other standards; certain standards and practices concerning supply for the public and private sectors; and certain import policies providing for a system of base prices.

Lastly, we can mention the non-tariff barriers identified by GATT²⁹ that are relevant to the Canada-U.S. case. In particular, these include measures classified in five groups: those related to the government's trade role; those concerning customs and administrative entry procedures; measures on standards currently in effect; those on certain trade restrictions; and, lastly, measures imposing restrictions on imports.³⁰ Table 2-5 shows the major forms of tariff and non-tariff barriers.

Some Weaknesses of Free Trade Areas³¹

An optimal allocation of resources would not come about in a regime of free trade since divergences in monetary, fiscal and, partly, social policies would distort competitive cost relationships. Thus, a certain degree of harmonization in economic policies becomes necessary.³²

This statement by Balassa provides an introduction to the weaknesses of free trade areas. A free trade area has many weaknesses because it is a form of negative integration, although the subsequent phases on the integration continuum progressively correct these weaknesses. Without producing an exhaustive list, we shall briefly mention the major inade-

**TABLE 2-5 Major Tariff and Non-Tariff Barriers
(categories and specific examples)**

Tariff Barriers

Customs duties

Taxes equivalent in their effects to customs duties:

- unilateral duties (discriminatory or otherwise) imposed on goods crossing borders
- duties that are part of the general national taxation system, but which benefit domestic products or the government that imposes them, as well as its nationals
- charges for services rendered when goods are shipped across borders (under certain conditions, these charges are considered as taxes equivalent to customs duties)

Non-Tariff Barriers

Quantitative restrictions

Measures equivalent in their effects to quantitative restrictions:

- import or export conditions and formal requirements (permits, technical health, quality, and safety standards, deposits, etc.) where, for example, these measures affect, formally or in practice, foreign products to a greater extent and/or are not commensurate with their purpose
- measures differentiating formally between intrastate trade and intra-area trade
- measures differentiating materially between these two types of trade
- measures fragmenting channels of intra-area trade
- state monopolies
- state-controlled markets
- private-sector supply standards and practices
- production and trade subsidies
- tax incentives
- customs evaluation regulations
- discriminatory bilateral agreements
- credit restrictions for importers
- certain monetary policies

quacies. (We shall be returning to these inadequacies in the section on the spillover process.)

- Because of the absence of common external tariffs, there is the possibility of trade distortions, as well as the numerous administrative costs that would be involved in controlling the origin of goods.
- The lack of free movement of all factors of production could create trade distortions in favour of countries that possess a larger potential of factors of production.
- As a result of the lack of common customs policies with respect to third countries, the creation of trade could be restricted by third countries that are competing against certain of the area's products on which high tariffs are not imposed by one of the partners.

TABLE 2-6 Major Types of Institution Found in Examples of International Integration

Weak institutions	Political and/or administrative in nature; limited in number; few powers; decision making based on consensus involving member units
Institutions of a medium-level integrative nature (with mixed characteristics)	Political and essentially ^a administrative in nature; limited in number; extensive powers, decision making based on consensus
Strong institutions	Political and technocratic in nature; in number corresponding to the range of state powers; extensive powers; supranational decision-making process.

a. Certain judicial bodies are not necessarily excluded.

- The absence of a common external tariff could prevent a certain equalization in the cost of imported materials and products that were being used in processing activities in the area.
- Monetary disparities could also undermine free competition in the area.
- The absence of certain common policies (regional, industrial, budgetary, fiscal, social, etc.) could work against the correction of imbalances because of an asymmetrical relationship between partners.
- The minimalist institutional framework usually encountered in free trade is not adequate for the purpose of attacking non-tariff barriers effectively or for formulating and implementing the necessary corrective policies. Also, this institutional weakness fails to provide the necessary integration framework for the socialization of the elites and the general public within the integration process.

Free Trade and the Institutional Question

For the sake of clarity in this section, we shall begin by defining the meaning of “institutional question” and by presenting our classification of the major categories of institutional framework that are used in international regional integration.

The term “institutional question” refers to the types of institution that should be adopted under a Canada–U.S. free trade regime and to the nature of their powers, as well as the manner in which they should operate at the decision-making level. As regards the major types of institution encountered in the various forms of international integration (in many cases, in mixed form), these are given in Table 2-6.

Before discussing the types of institution that should be established for a Canada–U.S. free trade area, we should note that the institutionalization theme is at the heart of current discussions concerning the

wisdom of closer ties between the two countries. This is not simply a question of law and institutional effectiveness with purely superstructural dimensions. It is linked to the general problem of possible spillover effects that could lead to other forms of socioeconomic integration and to a certain political integration between the two countries. Perceptions of such a relationship between institutional integration and socioeconomic and political integration are not without foundation. They are supported by empirical and theoretical studies emphasizing the possibility of a fundamental integrating role for institutions, which could lead to an integrative spillover process.

To clarify the institutional question in the Canada-U.S. free trade debate, we shall base our discussion on two themes: the proportional relationship between integrating institutions and the activities that are integrated; and the types of institution that should be considered for the Canada-U.S. free trade area.

The Proportional Relationship between Integrating Institutions and the Integrated Activities

From both a theoretical and an operational point of view, there is a close relationship between the content of an international regional integration process and the nature of its institutional framework. Although, in practice, international integration may, in its implementation phase, place a "maximalist" integration project within a "minimalist" institutional framework (as, for example, in the Belgium-Luxembourg Economic Union (BLEU) and Benelux, both of which, despite their high degree of integration, are equipped with intergovernmental decision-making bodies), it is nevertheless true that the nature and scope of the integration process generally determine, from a logical and operational point of view, what institutions will be established. Accordingly, there should be a directly proportional relationship between the institutional framework of any international integration project and the nature and scope of the activities that are integrated.³³

The reason for this proportionality rule in the politics of international integration is one of functional effectiveness: the further the integration process advances toward positive integration (toward the adoption of common policies, for example, particularly in fields that are controversial, complex, and directly related to the exercise of national sovereignty, such as trade, agriculture, industry, fiscal and monetary policy, competition, and so on), the more important it is that decisions concerning the formulation and implementation of joint policies should be made in a clear and coherent manner, with a community view. In general, this task cannot easily be performed by intergovernmental institutions, and it must instead be entrusted to strong central supranational bodies. The composition, powers, decision-making processes, actions, and effects

of these bodies must reveal a broad range of abilities, a capacity (both legal and political) for joint and effective decision-making, an operational independence and flexibility, with independent and effective decision-making mechanisms (the decision-making process in general and voting procedures in particular).

In the absence of such a proportional relationship (between the institutions and the integrated activities), we may generally expect, in the case of extensive integration but weak joint institutions (intergovernmental institutions), that one of two things will happen in the decision-making process. If there is a balance between partners of equal size, disagreements may lead to delays and to general paralysis, since the intergovernmental process will be such that there is no superior and autonomous authority (*de jure* or *de facto*) within the integrated unit that can take initiatives and make final, rapid, coherent, and effective decisions in controversial matters; instead, each member would be likely to defend its sovereignty and its own interests and positions, invoking the rule of equality, vital national interests, and the need for consensus. Alternatively, if there is an asymmetrical relationship, the weaker partner will often be tempted to use its veto, thus paralyzing the system; or it might be pressured by the stronger partner to stop blocking the intergovernmental process; or, even worse, it might be faced with a *fait accompli* by that partner.

International experience provides numerous examples of such dysfunctions and abuses, notably in cases where integration, while entering the partners' areas of vital interests and activities, nevertheless remains subject to the weaknesses in the institutions and decision-making mechanisms of the intergovernmental process. However, international experience also shows that partners may, for their own reasons, deviate deliberately (in either a maximalist or minimalist direction) from the proportionality principle. Their reasons may be of two kinds.

On one hand, the proportional nature of a strong institutional system is not justified solely by the material form assumed by the association. It is possible for the institutions to have their own integration goals and to pursue political goals, in addition to the objective of making the association operate smoothly. Institutions could be assigned an integrating role, thus becoming the driving force behind the integration process. Moreover, strong institutions could provide a framework for forms of association that are not highly integrated in their initial stages, in order more easily to encroach upon the national powers of member states, to review and aggregate partisan (particularly national) interests in order to determine the general interest, and so on. There is thus a political aspect which concerns the integrating role institutional components play in the integration process.

On the other hand, if we wish to slow down the integration process, to prevent it from going through new stages, to freeze it by respecting only

the letter of agreements, and to eliminate any possibility of future integration, it would be preferable, among other things, to equip the integration process with an intergovernmental mechanism that provides for a number of blockages in the decision-making system. Far from building anything Machiavellian into the design, we are simply suggesting that such an intergovernmental institutional structure, particularly for an association that is something more than a customs union, would constitute a deliberate act to protect national power, though it would also undermine the success of the association and compromise its chances for a spillover.

However, having said this much about the need for proportionality, we should not allow this rule to be negated by its exceptions; nor should we fall into the trap of absolute determinism by thinking that an intergovernmental decision-making system would, in all circumstances, necessarily prevent the maintenance or progress of the integration process. Where there is a certain symmetrical relationship between partners in a highly utilitarian association of states, with harmonious social communications and compatible value systems, intergovernmental arrangement will not always cause such a range of operational disadvantages and imbalances. On the other hand, in asymmetrical relationships between partners, even a free trade area would require institutions that are capable of formulating and effectively implementing common corrective policies. Table 2-7 illustrates the relationship between types of integrative institution and types of integration.

The Debate on Institutions for a Canada-U.S. Free Trade Area

Proponents of Canada-U.S. free trade maintain that the area's institutional system would be intergovernmental and unencumbering in nature. Although the exact plan for this type of institutional apparatus has not yet been clearly outlined, consideration could be given to a joint administrative commission to enforce free trade regulations (e.g., to enforce regulations on origin and to eliminate trade distortions; to supervise the removal of non-tariff barriers and to examine complaints pertaining thereto, etc.). There could also be room for an intergovernmental council, consisting of representatives of the executive branch of both governments, which would periodically examine progress made in free trade in general and in trade relations between the two countries. Lastly, there could be periodic meetings (either institutionalized or non-institutionalized) involving the elected representatives of the two countries.

In the minds of the proponents of free trade, these unencumbering and little-integrated intergovernmental institutions would be based on the restricted form of integration (negative integration) of a free trade area. Their purpose would be to prevent a spillover process — which could,

TABLE 2-7 Relation Between Types of Integrative Institution and Types of Integration (content, goals)

		Types of Integration (content and goals)	
		High Degree of Integration (content) but Desire for National Control of the Process and/or Brake on Spillover ^a	Low Degree of Integration (number and type of activities) but Desire for Spillover
High Degree of Integration (in terms of activities integrated) ^a	Strong institutions	X (EC)	X (ECS)
	Weak or medium-level institutions	X (BLEU, Benelux)	X (EFTA)

a. Examples of high degree of integration: common market, monetary union, economic union (partial or total).
 b. Examples of low degree of integration: cooperative association, free trade area, simple customs union (without elements of partial economic union).

as already demonstrated, give rise to a highly integrated institutional superstructure — and thus to dispel the fears of those who see free trade as the first phase on the continuum of economic and political integration, and who consider the initial forms of institutional integration under a free trade regime as being likely to lead to further stages in the integration process.

The debate concerning institutions for a Canada-U.S. free trade regime focusses on a certain number of questions, the major ones being as follows: Would we, in effect, have weak common institutions? What problems would result from such institutions? What difficulties would be involved in strengthening this type of institutional apparatus? Would the institutions be strengthened at a later date? What would be the consequence of such a situation? These questions lead us to a number of considerations.

First, in light of the comparative study of free trade areas involving industrialized countries (from the institutional point of view, the integration situation in the Third World is scarcely different), we are obliged to note that the proportionality principle is generally adhered to and that common institutions — which provide a framework for associations of states that are quantitatively and qualitatively integrated to a low degree — constitute, by their nature and powers, embryonic forms of institutional systems; one finds a small number of institutions which are administrative in nature and have political intergovernmental supervisory bodies with limited powers.

We may even cite the case of more highly integrated organizations, for example, with a customs union and elements of an economic and monetary union (BLEU and Benelux); they have opted for insufficiently integrated institutions because, among other things, they wish to limit possible spillovers, especially political spillovers. (Compare, in Table 2-7, the case of highly integrated organizations, in terms of integrated activities, with institutions that have a medium level of integration.) Does this mean that a Canada-U.S. free trade area would follow the same minimalist path with respect to institutions? In light of the following considerations, we cannot be certain.

It would be possible for the initial institutional framework of a Canada-U.S. free trade area to be integrated only to a small degree, in order to take into account, in accordance with the proportionality rule, the low level of integration between the partners (free movement of goods). This would also respect certain national susceptibilities, Canadian in particular, but American as well, since the United States, as a superpower, would not wish to submit to a supranational process that might oblige it to act in a certain way. Lastly, it would also prevent integration spillover. This framework might include, for example, a joint administrative or customs commission and an intergovernmental council at the level of the executives, with perhaps meetings (institutionalized

or otherwise) between the elected representatives of the two countries. This structure should not be fixed and unchanging, since problems arising from free trade and its interdependence with various other socioeconomic activities would require the partners to strengthen their common institutions; otherwise, disintegrating forces and dysfunctional phenomena could prevail, compromising the integration process.

An excellent example of the proliferation of institutions that can follow the creation of a free trade area can be seen in the institutional spillover experienced by EFTA, when its council and examining committee was followed by a series of new committees (customs committee, budget committee, committee of trade experts, consultative committee, executive development committee, agricultural review committee, and economic committee), as well as by a secretariat. This proliferation was the result of developments in domestic and international economic situations, and it was fostered by the very general provisions of the European Free Trade Association (EFTA) convention, which read as follows: "The Institution of the Association shall be a Council and such other organs as the Council may set up . . . [shall] make arrangements for the Secretariat Service required by the Association."

Thus there are certain problems which might lead to the need for greater institutionalization in Canada-U.S. free trade; they are difficulties that other free trade organizations have not resolved, partly because of weaknesses in their institutions and decision-making mechanisms.

First and foremost, there is the matter of non-tariff barriers. Their importance in the Canada-U.S. context, their sprawling form, their often hidden presence, and their ambiguous characteristics suggest the need for a common central power that is capable of identifying them and deciding on their removal. For example, within the EC (and we here refer to the free movement of goods, which is common to the EC and to other free trade areas), only the presence of the Court of Justice, which is an integrated judicial power with the authority of a supreme court in areas within its jurisdiction, has made it possible to identify a range of non-tariff barriers, known in particular as "quantitative restrictions and measures equivalent in their effects to quantitative restrictions," and to order their removal. On the contrary, in other cases such as those of EFTA and the New Zealand-Australia Free Trade Area (NAFTA), the absence of an equivalent judicial body has prevented common institutions from attacking the problem of non-tariff barriers with the same authority, reach, and effectiveness.

Secondly, quite apart from the question of non-tariff barriers, the enforcement of regulations on origin and the need to avoid trade distortions and other dysfunctions in the free trade area would suggest the need for a strong judicial or quasi-judicial power (an arbitrating body, for example). Such a need is all the more pressing in our case since the scope of Canada-U.S. trade — and its integration, in large part structural,

within an intrafirm trade context, as well as the scope of the two partners' foreign trade activities — would raise very pressing questions of origin and of trade distortions.

Third, the rules of free competition must be obeyed in order to give free trade its full meaning. However, the establishment and implementation of a competition policy would be a difficult task indeed, particularly in the Canada-U.S. context, where inter-firm agreements and dominant positions may be numerous, given the existence of major American monopolies, the location of development centres and multinationals' headquarters in the United States, and the structural imbalance that exists between the two partners. It thus calls for strong institutions. The example of the EC, in which a supranational commission, in cooperation with a true Court of Justice, has, though not without some difficulty, enforced the Treaty of Rome's rules on competition, indicates the high degree of institutionalization required to make executive and judicial powers strong.

Fourth, there are possible economic spillover effects (which we shall discuss in a later section of this paper) which should also encourage greater institutionalization within the Canada-U.S. free trade area. We are referring here to the very possible establishment of certain joint, corrective and/or complementary policies (political, social, regional, fiscal, industrial, banking, etc.) concerning free trade and related phenomena (often dysfunctional). These policies could be more easily adopted by strong joint institutions, which, in view of the imbalance between the partners, would be responsible for enforcing a compromise in the common interest, because intergovernmental institutions would not be able to fulfil such a role if they were purely administrative or political in character and lacked supranational powers; they would thus not be able to combine and express effectively the many political and socioeconomic interests of the two countries, which are so fundamentally asymmetrical, of a federal nature, pluralist, and divided in a number of socioeconomic spheres.

Without such institutions, policy formulation would become an arduous if not impossible task, with both countries tempted to correct, on a unilateral basis, the economic distortions and imbalances caused by a free trade regime that involves two partners with political and socioeconomic differences. Such action would exert strong disintegrating pressure. The need for institutional integration (i.e., for strong common powers of cooperation, initiative, decision making, and arbitration) is that much greater, since both countries have a federal superstructure with two levels of government. Their administrative, political, and economic life are subject to major horizontal fragmentation (i.e., at the federal level, at the provincial level, and at the interprovincial or interstate level) and to vertical fragmentation (i.e., relations between federal institutions and state or provincial institutions) and are characterized by

structured major socioeconomic groups, which have their own policies in addition to those of the various governments.

Does this mean that, after the first phases of free trade have been implemented and when the need for socioeconomic harmonization has been taken into consideration, this institutional spillover will be a spontaneous development, or at least one that is easily brought about? We think not, given the asymmetrical economic relationship between the two partners, as well as the political concerns of a superpower (the United States), which would prefer to be free to make its own decisions, and the concerns of a much weaker and domestically fragmented power (Canada), which might fear for its sovereignty, its autonomy, and its as-yet-incomplete national identity. Thus, our position on strong institutions is a long-term one, based on the need for successful free trade and socioeconomic and functional logic, without underestimating the real dangers for Canada's economic and political autonomy, as well as the need for the defence of the overall national interests of Canadians. The alternative would be dysfunctional development (disintegrating phenomena, unilateral action, violation of free trade regulations, and socioeconomic disturbances) in free trade that could threaten its continuation.

As an intermediate position, some may feel that there is a place for medium-level integration institutions; i.e., institutions with major powers which they would exercise in an intergovernmental manner. However, we do not find this idea without shortcomings (although it is preferable to having institutions with weak powers), since the imbalance between partners could lead to the weaker partner's defensive use of its veto and thus to paralysis in the decision-making process; or to the weaker partner submitting to pressures, exerted by the stronger partner, for an agreement; or to the weaker partner giving way in the face of a *fait accompli*. The socioeconomic and political obstacles already mentioned in connection with the difficulty of establishing strong joint institutions would also appear along the road to establishing institutions that embody a medium level of integration (i.e., major powers and an intergovernmental decision-making process).

In concluding this section, we should emphasize a more legal-institutional difficulty involved in establishing strong institutions for the Canada-U.S. area. There is a problem in setting up rules for majority decision-making: the dyadic nature of the partnership will not permit such a process, except in cases of asymmetrical (unequal) representation or weighted votes, which Canada could not accept without running the risk of remaining permanently in the minority.

In conclusion, the rejection, for political reasons in particular, of a sufficiently strong institutional apparatus for the free trade area could undermine the success of a free trade regime, especially in view of the need for corrective and complementary free trade policies; and it might even compromise the agreement on its establishment.

A Proposal for an Institutional and Decision-making Framework

Any realistic proposal concerning an institutional framework for a Canada-U.S. free trade area must take three things into account. First, there is the fact that, according to the proportionality rule, free trade, which is a form of negative integration, can exist within a minimalist institutional integration framework. Secondly, there is likely to be hesitation on the part of both partners to accept strong joint institutions; the United States, as a superpower, will not wish to submit to joint supranational authorities, while Canada will hope to avoid the political spillover effects resulting from a high degree of institutional integration. Thirdly, there will nevertheless be a need for certain effective institutions (perhaps at a medium level of integration in terms of powers, even if they have to operate in an intergovernmental manner); and these institutions must be capable of attacking, for example, the highly complex and controversial question of non-tariff barriers, and of formulating the corrective and complementary policies that will be called for by the liberalization of trade in a situation of asymmetrical interdependence.

In this context, the basic philosophy of our institutional plan is multi-dimensional. In particular, it contains the following elements: an initial minimalist approach to the scope of the integrated powers, but also an open system allowing for the exercise, at a later stage, of broader powers; a principle of intergovernmental institutions (composition, decision-making process); a dualistic rather than integrated structure; and a principle of parity, with possible exceptions with respect to the less important bodies (e.g., secretariat, committees of experts, consultative policy bodies) in order to accommodate the difference in size between the two partners.

Given these components, and in view of the existing examples of international regional integration involving industrialized and, in many cases, advanced industrial societies, we can draw on two integration frameworks when making our proposals concerning institutions, although, except where indicated, we shall not be following these frameworks exactly. These two frameworks are the European Free Trade Association (EFTA)³⁴ and the Belgium-Luxembourg Economic Union (BLEU).³⁵ However, we do not wish to identify ourselves with either one; nor shall we refer here to NAFTA or ANZCERTA, since it does not provide an institutional model.

EFTA was chosen because it is a modern free trade area involving industrialized countries; because it has successfully addressed the problem of tariff barriers, paid special attention to the question of non-tariff barriers; and because it possesses a flexible, pragmatic, and evolving institutional structure. We selected BLEU, which represents a form of monetary and economic integration, rather than a simple free trade area,

for two reasons. First, BLEU has an institutional structure which, unlike the multilateral composition of EFTA, governs a form of dyadic integration; this will enable us to determine how a free trade regime involving two partners may be organized institutionally and in terms of decision-making rules. Secondly, although BLEU is intergovernmental in nature, it provides an institutional model at a medium rather than low level of integration in terms of powers conferred on the institutions, even though these powers are exercised essentially in an intergovernmental manner based on consensus. Thus, this model is relevant to the Canada-U.S. free trade area, which, because of the possible distortions and imbalances that it could generate, requires the effective intervention of joint institutions (even intergovernmental in nature) equipped with broader powers.

It goes without saying, therefore, that the following proposals represent neither our position in the institutional debate nor the desired framework from a rational decision-making point of view; rather, they represent an outline of what appears to us, in institutional terms, to be politically acceptable to both partners. However, we do not neglect certain aspects of the dyadic, asymmetrical, and partial nature of the free trade integration regime envisaged therein.

Our proposal for the institutional framework of a Canada-U.S. free trade area is set out below.

COMMITTEE OF MINISTERS

Contrary to the minimalist institutional positions, according to which a structure of administrative institutions would be adequate for a free trade regime, we think that it is necessary to establish a committee of ministers. Comparative experience with international integration, even of the free trade type, shows that such an institution is useful; it would also demonstrate a political will to maintain and promote the liberalization of trade; and Canada would find in it a political control authority that could prevent technocratic bodies from promoting a neofunctionalist spillover process which would lead to other more advanced forms of integration.

This committee would consist of the representatives of both governments, represented by two delegations. Each delegation would include the minister for foreign affairs (or a representative) and other ministers (or their representatives) who might possibly be concerned, on an ad hoc or permanent basis, with the problems of free trade — for example, the ministers of foreign trade, industry and regional development, finance, etc. In this way, far from being an integrated body, the committee would represent an intergovernmental body which, as in BLEU, would consist of two delegations, each headed by the minister for foreign affairs or by someone designated by him. The committee could be chaired by the

head of the delegation from the country in which each meeting was held; or it could be chaired on a rotational basis, in alphabetical order, by each delegation head for periods of, for example, six months.

As the major decision-making body, the committee of ministers would adopt decisions concerning both member states; following the same practice as BLEU, the two member states would have to incorporate these decisions in their own domestic judicial order, "either through the adoption of legal or regulatory measures having identical content, or through the introduction in one of the countries of measures that are in effect in the other country, or by means of the publication in both countries of joint measures directly in effect for the entire area."

With respect to the decision-making process, decisions could be made by unanimous assent within the committee. BLEU provides for the mutual agreement of the ministers present or for an agreement reached by means of a broadly used emergency procedure. Thus, to prevent problems, two elements could be introduced. First, only major decisions would require consensus. Secondly, there would be a procedure for emergency powers and for the delegation of powers between committee sessions. This would enable an administrative commission whose mandate would come from the committee to go ahead, with the agreement of both delegations comprising it, and make decisions that would be implemented immediately in the free trade area, subject to ratification by the committee of ministers (explicit or implicit).

ADMINISTRATIVE COMMISSION AND SECRETARIAT

The board would consist of civil servants from both governments (for a standing committee of national representatives), divided into two national delegations, and would reach decisions through the unanimous agreement of both delegations. As in BLEU, the national delegations would be constituted so as to ensure that those ministries mainly interested in the area's affairs would participate in the administrative commission's work. The commission could be chaired by one of the two delegation heads on a rotational basis to be decided upon.

As its name indicates, the commission would be administrative and executive in nature. It would implement the free trade agreement by acting as a second line of authority in cases of disagreement within the customs commission; by providing regular liaison between the two governments; by preparing and submitting draft decisions to the committee of ministers; by being assigned by the committee to settle matters directly in the case of emergencies, and also on other occasions; and, lastly, by intervening, as outlined below, in the decision-making process involving various specialized area committees.

Meeting regularly during the year, the commission would make decisions through the unanimous agreement of its members; in cases of

disagreement, the matter concerned would be referred to the committee of ministers. A joint administrative secretariat, which would not necessarily be based on a principle of parity, would provide the administrative support to the commission on a permanent basis.

CUSTOMS COMMISSION

The customs commission would be somewhat similar to the BLEU customs council and to the EFTA examining committees, consisting of civil service specialists who would form two delegations and would act through mutual agreement. The customs commission would have a variety of roles: it would enforce regulations on tariff removal and on origin; it would reach decisions on complaints concerning trade distortions and violations of rules for the free movement of goods; it would be given the power to make decisions about compliance with regulations eliminating certain tariff barriers; it would prevent the enforcement of new non-tariff restrictions that were deemed illegal; and it would draw up new proposals on the abolition of other existing non-tariff barriers.

Although it would be preferable to establish a judicial body that would be responsible, among other things, for the question of non-tariff barriers, the difficulties involved in imposing a system of binding legal decisions on a superpower encourage us to follow the EFTA model, under which examining committees act as auxiliary judicial bodies. Divided into preparatory examining subcommittees, the customs commission would reach its decisions through the unanimous assent of its members. In the case of disagreement, the administrative commission would make the final decision, and the committee of ministers would intervene only if there was disagreement within the administrative commission.

SPECIAL COMMITTEES

A Canada-U.S. free trade agreement could allow the committee of ministers to create various special committees at a later date, and in accordance with the area's needs and the desire of two partners for further integration. In particular, these committees would address the problems of economic development and of the balanced distribution of the costs and benefits of trade liberalization. Following the EFTA model, we could consider an initial series of special technocratic committees (consisting of civil servants and outside specialists), joint (i.e., with no delegation structure) or dualistic committees (structured in two delegations); these committees could be with or without parity in representation, a matter that could be decided in the initial years of the free trade area's operation.

The committees would include a budget committee, a committee of

trade experts, an economic and social advisory committee (including representatives from the two countries' various socioeconomic sectors), and an economic development committee, which would be responsible for correcting regional imbalances and for handling industrial reorganization, etc. These committees would submit study reports and decision recommendations to the administrative commission through its secretariat, and the administrative commission would then submit proposals to the committee of ministers or would act directly within its own powers. When the subject was appropriate, the committees would also submit study reports to the customs commission.

WHY NOT A COURT OF JUSTICE?

For a small country, the greatest protection in international organizations is the law and legal institutions to safeguard and enforce the legal rights and obligations.³⁶

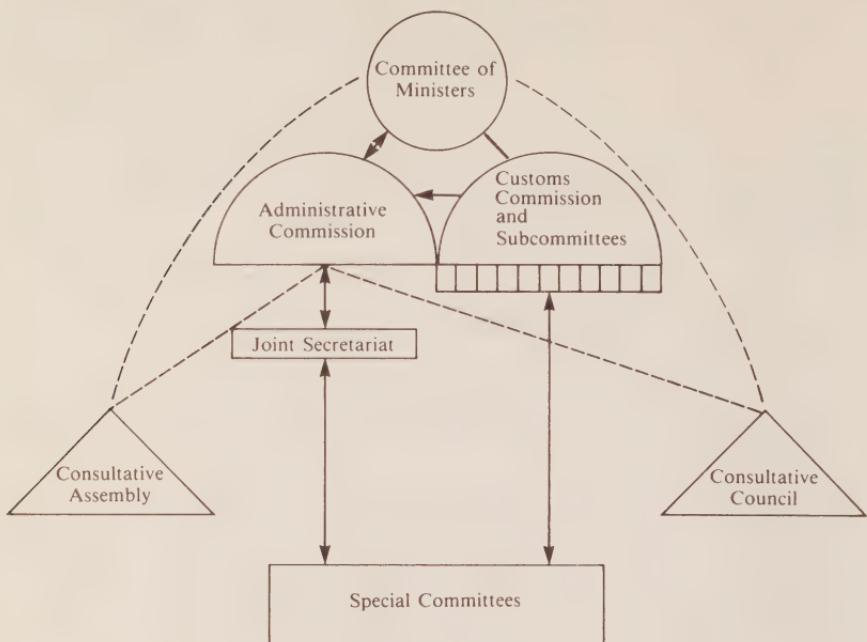
There is a great deal of political risk involved in holding a major power to contractual obligations through judicial mechanisms. The institution involved may simply disappear. For this reason, despite the great need in Canada-U.S. free trade for control over the smooth operation of the liberalization process (for example, with respect to non-tariff barriers), only the intergovernmental institutional model, which is political and administrative in nature and involves consensus decision making, appears to be realistic, at least in the initial stages of the process.

A FRAMEWORK FOR FEDERAL-PROVINCIAL INTERACTION

The federal nature of the two partners will give rise, at both the policy level and the institutional level, to problems of consultation and coordination between the two levels of government and to all the attendant risks of fragmentation. Consequently, there must be a framework for federal-provincial or federal-state interaction within each country, as well as a common body representing the central and federated governments of both member countries. Consideration should be given to the establishment of a consultative assembly (not necessarily with parity in representation) of elected representatives from both legislative levels in each country and/or a consultative council (again not necessarily with parity in representation) of representatives from both levels of government in each country.

The various institutions and relationships shown in Figure 2-2 illustrate the nature of this institutional apparatus.

FIGURE 2-2 Proposed Institutional Apparatus for the Canada – U.S. Free Trade Area



Legend:



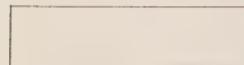
Political institution (intergovernmental, dualist, with parity in representation, small in size)



Administrative and executive institution (intergovernmental, dualist, with parity in representation, small in size)



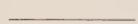
Subsidiary administrative institution (integrated, not necessarily with parity in representation)



Technocratic institution staffed by civil servants and outside experts (inter-governmental, dualist or integrated, not necessarily with parity in representation)



Political consultative institution (intergovernmental or interparliamentary, large in size, dualist or integrated, not necessarily with parity in representation)



Organic relationship



Decision-making process relationship



Relationship priority

Source: For this graphic representation, we have drawn on M. Virally, *L'Organisation mondiale*, 1972 (he refers to the United Nations).

Proposed Canada–U.S. Free Trade in a Comparative Context

As we shall see in the section on spillover, experiments in international integration have often been used to back the arguments of both those in favour and those against Canada–U.S. free trade. This is especially true of the former, who see in such attempts proof that there is no integration spillover, as well as opportunity to establish a free trade area with a fairly embryonic institutional framework. Most such comparative references involve the question of spillover and institutional superstructure.

In our introductory chapter, we made a number of general comments to the effect that such comparisons have been used inappropriately in specialist literature and official documents on the question of free trade between Canada and the United States. Such misuses include general references to other free trade areas, without the thorough comparative analysis that is needed in order to draw any relevant conclusions. They also arise from inadequate familiarity with the integration examples adopted for purposes of comparison; in this connection, they do not comment on the various spillover effects generated by such free trade areas as EFTA and the New Zealand–Australia Free Trade Area (NAFTA), or on the area that succeeded it, the Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA). Another failing is that the literature has not made enough use of NAFTA, which in our opinion is of significant interest for comparative purposes as a dyadic and asymmetrical integration model, because it has many more points in common with the proposed Canada–U.S. agreement than the EFTA. Finally, the literature does not contain any discussion of the differences between the Canada–U.S. situation and the free trade experiments to which it is compared — a discussion that would make it possible to establish a proper basis for comparison.

This said, and given the issues involved in this part of our study, we shall use comparisons in three ways: first, to establish a number of special features of the Canada–U.S. situation in order to establish the limits of the comparison paradigm for this study; secondly, to construct a table of the integrative potential (namely, the conditions of integration appearing before, during, and after the establishment of an integrated area), a table that compares the possible future Canada–U.S. free trade area with the EFTA³⁷ and the NAFTA/ANZCERTA;³⁸ and, thirdly, to support the thesis that there would be spillover in the Canada–U.S. free trade area, by presenting a number of arguments based on the integration experience of the other free trade areas. We could have concluded this part of our study by citing the institutional experiences of the free trade areas, but we did not feel that this was required; the extreme flexibility and the limited integrative nature of free trade institutions is an uncontested fact (even though we believe that a more developed institu-

TABLE 2-8 Special Features of CUFTA, Compared to Other Contemporary Free Trade Areas Involving Industrialized Countries (EFTA and NAFTA/ANZCERTA)

Very high integrative potential (integration conditions prior to establishment of a free trade area)
Bilateral North American system less heavily penetrated than other regionally integrated systems
Free trade with a diplomatic, strategic, and socioeconomic superpower (the United States)
Geographical contiguity, absence over large parts of the border of natural boundaries, proximity of population
Incomplete Canadian nation-building process
Fragmentation due to various levels of government in the Canada–U.S. dyad
Strongly asymmetrical dyadic and structural dependency links
Absence of real alternative solutions to the problem of regional integration in Canada

tional framework would be required for a Canada–U.S. free trade area, for reasons explained in the preceding section).

Specific Features of Canada–U.S. Integration

There are many problems involved in comparing a Canada–U.S. free trade area with other free trade areas involving industrialized countries; nevertheless, it is a comparison that is often made in specialist literature, in order to answer the institutional question, to explore the risk of spillover, etc. We shall refer only to the main comparisons here, using them as the parameters of a comparative paradigm for describing the content and development of a Canada–U.S. free trade area (which will be referred to hereafter as CUFTA, in accordance with current practice).

The main features distinguishing the Canada–U.S. situation from that of existing free trade areas among industrialized countries (the EFTA and NAFTA/ANZCERTA, for example) are summarized in Table 2-8. These features, which are described below, are of major importance for the purposes of analysis.

First of all, there is a very high integrative potential for the Canada–U.S. relationship which does not exist to the same extent and intensity in other areas. (This will be explored in the next part of this

section.) Canada and the United States have become so similar as societies over the years (through concentrated transnational and trans-governmental relations, through increasingly similar attitudes and values, intense social communications, strong socialization factors, and deeply rooted structural economic interpenetration) that free trade would be following an already widespread integration pattern; in other instances of free trade integration, the prior integrating potential has been much lower (see Table 2-9).

Another difference is that the bilateral North American system is less deeply penetrated by the international system and by its subsystems than the other regionally integrating systems are. Third, there is the fact that the United States is a superpower (diplomatically, strategically and socioeconomically); this accentuates the uniqueness of the Canada-U.S. situation. In other areas, the asymmetry of power has not been so pronounced or so multidimensional.

A fourth feature is the geographical contiguity and the absence of a natural boundary over large parts of the border separating the two countries, as well as the proximity of most of Canada's population to this border. This further exposes Canada, which is already vulnerable economically, to the attraction of the development centres and activities located south of the border (e.g., the head offices of multinationals, buying and selling markets, population centres, communications lines, etc.). In other areas, such as England and Ireland, the EFTA countries, and New Zealand and Australia, natural boundaries and distance provide clear borders — in terms of objective social communications and transactions, as well as in terms of subjective perceptions and images.

Then there is the fact that the nation-building process is incomplete in Canada, with all the attendant attitudinal, political, institutional and economic fragmentation that this involves. This stands out in strong contrast to the integrated states that are partners in free trade areas involving industrialized countries. Speaking of fragmentation, it should be pointed out that both Canada and the United States are federal systems. This makes them even less cohesive compared to the other areas, in which not all the parties involved are federal systems. In addition, of course, there is great fragmentation in one of the CUFTA federal systems — the Canadian federal system.

Furthermore, the dyadic nature (including both asymmetry and structural dependence) decrease the relevance of the comparison with EFTA. Finally, the absence of real solutions to an alternative regional integration for Canada adds to CUFTA's distinctive characteristics.

These differences should not be examined in isolation; rather, they should be considered as a whole, since the ways they interact and their possible cumulative effects tend to emphasize still further the uniqueness of the Canadian situation.

TABLE 2-9 Canada–U.S. Relations: Integrative Conditions and Their Globalizing Comparative Evaluation (qualitative and global evaluation covering all the partners) Conditions When or Before the Zones Were Created

Integrating Structure, Integrating Conditions (before or at the time of the area's creation)	CUFTA	EFTA	NAFTA/ANZCERTA
1. Symmetry in the economic size of the partners (not in terms of GNP but of GNP per capita, of income per capita, of industrialization, of production, of consumption, of exports, etc.)	Average	Low–Average ^a	Low–Average ^b
2. Pluralism of the society (open and diversified dialogue)	High ^c	Average–High ^c	High ^c
3. High level of transactions (commercial and other economic transactions)	High	Low–Averaged ^d	Average ^e
4. Multiplicity, intensity and balance of social, political, and diplomatic communications, in the context of “a secure community”	Average–High ^f	Low–Average ^g	Average–High ^h
5. Similarity, complementarity, or compatibility of the values (sociocultural, economic and political) of the elites	High ⁱ	Average ^j	Average–High ^k
6. Internal crisis (or perceived crisis) in each society concerned	Low–Average ^l	Low	Low
7. Integrative or disintegrative external pressures (or perceived pressures)	Average ^m	High ⁿ	Average ^o
8. Capacity of the elites to adapt and respond	Average ^p	Average–High ^q	Average–High ^r

9.	Perception of possibility of bigger gains and/or lesser losses, as well as their equitable distribution among the partners	Low–Averages ^t	Average ^t	Average ^t
10.	Integrative intentions of leaders when the integrated zone was created (extent of the scope of the integrative project)	Low	Low	Low
11.	Importance of powers to give to the zone and type of institutions and decision process	Low	Low	Low
12.	Importance of sensitivity (emotional and/or utilitarian — of attitude and/or behaviour) of the elites and general public (pressure groups and public opinion) to the idea of free trade	Average ^u	Average ^v	Average–High
13.	Absence of internal or international integrative alternative	Average–High ^y	Average ^z	Average–High ^y
14.	Global evaluation	Average–High	Low–Average	Average
a.	The presence of Great Britain (until its entry to the EC), on the one hand, and of Iceland and Portugal, on the other, reduces the symmetry.			
b.	Because of the weaknesses of New Zealand's industry.			
c.	In the three cases, there exists a pluralism that favours a diversified and open dialogue between proponents and opponents of free trade. In the case of NAFTA/ANZCERTA, particularly, much opposition has been surmounted at the level of the manufacturing sector and the New Zealand political elites. (Low variable, however, as concerns Portugal, when EFTA was created.)			
d.	It was rather the will to react to the creation of the Common Market and to favour trade development than the scope of the existing trade that favoured the creation of EFTA. The ties were, however, closer between Great Britain and the Scandinavian countries.			
e.	In spite of geographic isolation (from most of the industrialized countries) and a common colonial history, the transactions before NAFTA were limited.			
f.	Even today, their level does not approach that of the concentration of partners in Canada–U.S. trade.			
g.	In spite of the multiplicity and intensity of these communications, their asymmetry reduces the intensity of the variable.			
h.	Because of the macroregional aspect and the linguistic and cultural barriers, etc. (especially if we take Portugal into account), the exception being, of course, the relations between Great Britain and the Scandinavian countries.			

TABLE 2-9 (cont'd)

- i. Because of the diplomatic-administrative, economic and cultural interpenetration, and thus the interpenetration of information, values, images, attitudes, etc.
- j. Because of the difference in political culture and the limited social communications between certain partners of the zone, etc.
- k. Slightly diminished because of varied postwar ethnic influx in Australia.
- l. Refers primarily to crisis in the Canadian system.
- m. American trade problems, Canadian diversification problems, limited GATT action on NTB, etc. In this connection, pressure is strong on Canada and low on the United States, hence the average.
- n. In view of the attraction of the EC, etc.
- o. In the case of ANZCERTA, strong growth of ASEAN; NICs; Japanese development and protectionism; entry of Great Britain into the Common Market; decline of economic relations within the Commonwealth; need to complement relations with other markets (e.g., the United States).
- p. Average, in view of the difficulties Canadian political elites are having in solving problems of fragmentation and agreeing on domestic and external economic policies, etc.
- q. The evaluation is not high, because there was some hesitation and disagreement among British political and socioeconomic elites on the question of whether to enter the Common Market or to establish a free trade area, or again to strengthen the Commonwealth, etc.
- r. The evaluation is not high, because of a degree of protectionism found among some New Zealand socioeconomic elites and a politicization of the question, primarily in New Zealand. The governments were able, however, to overcome opposition to the establishment of NAFTA and ANZCERTA.
- s. Because of the limited interest in the United States and because of Canadian doubts about the likelihood of benefits, cost risks, and equality of distribution.
- t. Average, because of fears of distribution imbalances for the smaller partner resulting from asymmetry, but also because of hope for a degree of economic stimulation arising from the opening up of larger markets and the safeguards and protection measures agreed upon.
- u. Higher evaluation for Canada because of social communications, similarity of values (supra) and utilitarian expectations (especially at a time of socioeconomic crisis), tempered by American indifference or reservations, but also because of the hostility to the free trade proposal on the part of some sections of Canada elites and the general public.
- v. Because of some weaknesses associated with variables 3, 4 and 5.
- x. Not high because of a number of New Zealand fears at the utilitarian level (benefits of the area and how they will be distributed); however, it is strengthened by integrating efforts made by political elites and by various cultural and socioeconomic pressure groups.
- y. In view of the absence of other valid regional substitution frameworks (in terms of integration), especially for the smaller partner, and the problems it experiences in diversifying its external economic relations.
- z. Possibility for others to develop microregional integration experiments (among the Scandinavian countries, for example), even though the problems involved in the Scandinavian integration or the difficulties for an alternative integration framework available to a number of countries (Austria, Switzerland) changes the intensity of the variable.

Integrative Potential of the Canada–U.S. Relationship and Comparison with EFTA and NAFTA/ANZCERTA

As we underlined above, one of the features of the Canada–U.S. situation is the extent and intensity of the integrative variables underlying relations between the two countries prior to the establishment of a free trade area.

The significance of this integrative potential is threefold. First, it indicates the limiting parameters of a comparison between CUFTA and other free trade areas. Second, it makes it possible to forecast the high likelihood of some form of Canada–U.S. integration. Third, it suggests types of possible spillover from Canada–U.S. free trade, insofar as one of the conditions of the spillover is, as we shall see later, qualitatively and quantitatively strong integrative potential (“background conditions”).

This makes it possible to establish, in terms of integrative potential, a table of variables favourable to CUFTA, which can be used to evaluate and compare CUFTA with other free trade associations. For the latter, we selected two free trade areas: EFTA and NAFTA/ANZCERTA. The EFTA, the European Free Trade Association was established in 1960; since the entry of Iceland and the departure of Great Britain and Denmark to join the Common Market, it consists of six countries: Austria, Iceland, Norway, Portugal (which in 1986 becomes a member of the EC), Sweden, and Switzerland. In addition, Finland is an associate member. NAFTA, the New Zealand–Australia Free Trade Area, was established in 1965, to be replaced in 1983 by a new and more integrated association, ANZCERTA, the Australia–New Zealand Closer Economic Relations Trade Agreement.

There are several reasons why we chose these two free trade areas for comparison with CUFTA. One is the fact that EFTA and, to a much lesser degree, NAFTA are often cited as examples both by proponents and detractors of free trade. Secondly, in order to make a valid comparison, we needed to choose free trade areas whose parties are industrial countries. Also, we wished to be able to refer to free trade associations that are still active. Finally, we needed to have at least one asymmetrical dyadic area among the examples so that we could avoid using only EFTA in the comparison — something that is often done, even though EFTA is a multilateral framework and therefore less suited, in our opinion, to comparison with CUFTA.

Comparison of Positions on Spillover

Since spillover is examined in this paper's final section, in which we give a definition of the term and present a model of prediction variables, we shall keep our observations at this stage to highlighting a number of

spillover phenomena found in free trade areas, especially in the two areas we have selected for comparison, namely EFTA and NAFTA.

It must be pointed out that the possibilities and stages of spillover in a free trade area are limited by the fact that, according to the arguments of the neofunctionalists, spillover arises in advanced and politically inspired economic groupings, especially in a common market. In "dirigist" economic theories, which will also be discussed in the final section, it is nevertheless possible to find arguments for a functional linkage of tasks which correct the socioeconomic disturbances resulting from free trade (especially where there is asymmetry between partners) or which are complementary to the system of a free circulation of goods. Practice confirms that a number of spillover phenomena occur in free trade areas; it also contradicts those proponents of Canada-U.S. free trade who do not believe that there will be any spillover effects and who hold that it would be possible for the future CUFTA to be made stable simply by liberalizing trade and giving CUFTA no more than an embryonic institutional framework. This is an appropriate place to illustrate a number of spillover cases that arose in EFTA and NAFTA.

With the EFTA there was a double spillover: the first affected the liberalization regime and economic policies; the second concerned the growth of an institutional apparatus for the area. The liberalization regime led to increased free trade by solving a number of problems involving non-tariff barriers, by eliminating some restrictions on services, as well as by special agreements (signed after 1960) on fishing and agriculture, and by harmonizing some international economic policies of the member countries (in agriculture, general trade, etc.). As for the spillover at the institutional level, one can obtain some idea of this by noting that, based on the institutions listed in the Stockholm Convention, as well as the vague references to secretariat services, the EFTA succeeded in developing a key group of second-line institutions such as the secretary general and the special committees (e.g., customs committee, budget committee, committee of trade experts, consultative committee, economic development committee, agricultural review committee, economic committee, and the committee of members of the parliaments of the member countries. These bodies had considerable spillover of functions and policies.

The spillover effects are equally clear for NAFTA. This association began with a very partial and restricted form of free trade; but with the establishment of ANZCERTA in 1983, it moved to a form of free trade that was quantitatively and qualitatively much broader, with an automatic and progressive lifting of customs barriers (see the new "Closer Economic Relations Trade Agreements," 1983). Harmonization measures for agricultural policy were also introduced, some of them being measures for a common external agricultural policy. There was also a harmonization of policy in the fostering of export markets and public markets. There was

an effort to harmonize economic (especially trade) policies and agricultural (e.g., marketing) policies with third parties in general and with those of the South Pacific in particular. Two cultural foundations (one in Australia and the other in New Zealand) were established for promoting ANZCERTA objectives. In addition, there may be other forms of spillover, such as increased similarities in economic policies and institutionalization of the area.

It is expected, in fact, that ANZCERTA will provide considerable impetus for additional bilateral economic integration and policy coordination measures in the near future. This will set new constraints on national autonomy by regulating areas such as transport, corporation law, foreign investment, and the external tariff structure. The need for common legal authorities for joint application of regulations in these areas is already being considered by some politicians, even though the existing CER agreement does not include any such provisions.³⁹

Some Negotiating Behaviour Suggestions, Based on ANZCERTA⁴⁰

The ANZCERTA negotiations suggest a number of behaviour guidelines which might be useful in negotiating the Canada-U.S. free trade area. We summarize them below, making no attempt to provide an exhaustive list, since we wish to keep the study to a manageable length.

- The establishment of mixed negotiating teams, including government representatives and technocrats, would be necessary. The question of representation or consultation for the federated units should also be examined in this connection.
- During the negotiating process, it would be desirable to establish mechanisms for parallel ongoing consultation and information with various domestic players who represent economic, political, and sociocultural interests in states, provinces, pressure groups, etc.
- A management process model, rather than the classic diplomatic negotiating model involving crisis resolution and dispute settlement, would be preferable, especially for the early stages of negotiation.
- Continual political supervision at a high governmental level, along with occasional political intervention in the negotiations, especially at the advanced stages, would also be of great assistance in unblocking technocratic negotiations and in correcting, if necessary, problems resulting from bureaucratic and technocratic positions.
- This political presence would make it possible to keep the negotiating process open to public opinion. This openness would also allow both governments to socialize those segments of society that are opposed to free trade or are poorly informed about it.
- A global approach should guide the politicians involved in negotia-

tions if they are to avoid being drawn into technical disputes and fragmented sectoral discussions. The bargaining process should thus be a mixed one and should be combined with a political process.

- The principle of automatic lifting of customs barriers (i.e., specified percentages and time frames for lifting customs barriers to prevent the delays that would be involved in new ad hoc negotiations at each stage of the lifting of customs barriers) should underlie and guide the bargaining process; the free trade should also be gradual and evolutionary, open to the idea of corrective and complementary harmonization for matters involving competition, industrial and regional development, social adjustments, external trade, etc.
- Efforts should be made to establish a common bargaining language in order to prevent delaying tactics, inflexible positions, misunderstandings and conflict-producing dialogue methods.
- The concept of a package deal should also find a place in the bargaining process. In fact, since the objective and interests of the two countries in free trade are convergent rather than identical, linkage among various free trade sectors would become desirable (e.g., the lifting of customs barriers for some sectors that are of interest to Canada, with a corresponding concession in other sectors for the United States).
- It is absolutely essential that the negotiators should constantly take into consideration the evolution of the international environment. In fact, one of the main reasons why we suggest that the bargaining process should be kept open to the outside world (with, moreover, information provided to our partners on the progress of negotiations) is that we shall be able to observe the reactions of other countries — Third World and major industrial countries — to a regional and hence preferential free trade area. An open bargaining process will also enable us to take account of any resulting patterns of international economic relations, as well as possible reactions from GATT (especially to sectoral free trade) on questions of incompatibility.
- A thorough prior and continually adjusted evaluation of Canada's bargaining capabilities is necessary, particularly in view of the asymmetry of the Canadian and American bureaucracies, in order to avoid spending too much energy on the bargaining process, which could prevent the Canadian government from dealing effectively with the domestic and international problems of the day, especially crises.
- Unlike others, we do not have in mind a type of open-ended free trade that would become open to other partners. Such a process would complicate the calculations, since one would have to decide which elements of free trade to keep open to others; such a process would also make it impossible to do an accurate calculation of the adjustment costs and the attendant reorganization measures required for Canada. Canada must know in advance whether it is negotiating the establish-

TABLE 2-10 Some Guidelines for CUFTA Negotiations

1. Establishment of mixed teams (bureaucrats-technocrats, government representatives)
2. Keeping regular consultation and information channels open to various segments of both societies
3. Management process model, especially for early stages of bargaining
4. Constant political supervision at high government level and periodical political intervention in the negotiations
5. Opening of the bargaining process to public opinion and process of socialization of the opponents
6. Overall (global) approach
7. Gradual and evolutionary free trade principles with automatic lifting mechanisms for customs barriers
8. Establishment of a common bargaining language
9. Acceptance of the principle of package deal and linkage
10. Opening of the bargaining process to the world (closely following the reactions of other countries and the international situation)
11. Prior and constantly adjusted evaluation of Canadian bargaining capacities
12. Prior decision on whether to opt for open-ended free trade or closed bilateral free trade

ment of a Canada-U.S. market or a wider international market, because the extent and nature of the economic restructuring required (modernization, specialization, economies of scale) are partly dependent on the decision.

It goes without saying that these policy-oriented suggestions are placed in the perspective of the Canadian decision for free trade, and that they do not constitute a personal position favouring a free trade option. In this study, we are striving to present a balanced view on the question of CUFTA, rather than to take a stand for or against a free trade area.

Spillover as it Might Occur in Canada-U.S. Free Trade

The possibility of a spillover process, which could lead a Canada-U.S. free trade area toward more advanced forms of economic integration and which might also in the long run bring about forms of political and cultural integration, has long been at the heart of the debate between proponents and opponents of the free trade option. While the former have always rejected the possibility that there might be any economic-political or cultural spillover, the latter have always argued against free trade for cultural and political reasons, without always calling into

question its economic merits. Before presenting the arguments of both sides, we shall devote the first part of this section to an analysis of the concept of spillover.

The Concept of Spillover

In general, spillover refers to an evolutionary process of a form of international regional integration over its entire integration continuum: association of cooperation (economic, political, cultural, military, etc.); free trade area; customs union; common market; monetary union; partial economic union; full economic union; and political union stemming from full economic union. More specifically, the concept refers to various levels of spillover, corresponding to various levels of integration. It is thus possible to have institutional spillover, spillover of powers, jurisdiction and functions, policy spillover, attitudinal and behavioural spillover, transactional spillover, and, more generally, social communications spillover. In this section we shall primarily investigate a general spillover that can affect all levels: institutions, powers, jurisdictions, functions, and policies. As for its dimensions, there is economic spillover, political spillover, cultural spillover, etc., with economic spillover lying before political spillover in the theoretical continuum, and with cultural spillover linked to economic and political spillover.

To describe the spillover process (especially spillover extending to the more advanced stages of economic integration which can affect that political sphere), neofunctionalism initially developed a theory of automatic spillover; this is the automatic movement from a lower integration stage toward an integration stage farther along the continuum, following a dynamic linking of the tasks, gaps, and needs of a given integration stage that leads to the next ones.⁴¹ This version of automatic spillover was modified in the late 1960s by the introduction of the concept of cultivated spillover, which held that a major political decision would be required to move toward more advanced stages of integration.⁴²

Two restrictive parameters often surround this neofunctionalist view of spillover. The first is that, according to the neofunctionalists (notably Haas),⁴³ the economic and political spillover is mostly observed in cases of politically inspired economic integration. Secondly, the starting point of a spillover is normally taken as an economic integration that is usually located at a common market level (and which therefore has enough force at an advanced integration stage to release the mechanisms). According to Haas,

spillover in scope is confined to decisions and objectives relating to the realization of full benefits from an existing common market. It has not operated markedly in free trade areas; nor has it been true of all policy or decision sectors in common markets (e.g., energy policy, transport).⁴⁴

The author of the above quotation expresses himself in terms of a favourable context and historical and political experience in international integration. Moreover, he refers to a spillover toward the highly advanced phases of economic and political integration. One cannot exclude the possibility of a certain initial spillover movement in the Canada-U.S. case, i.e., the movement from a sectoral or partial and imperfect free trade to a wider and more complete free trade; the movement from free trade to a customs union (with or without common commercial policies); and the establishment of certain common or harmonious policies to correct and complement free trade, which, because of the asymmetry of the countries involved, would have many distortions and imbalances (trade, regional, industrial, economic, social, etc.). Thus, we should not dismiss out of hand the possibilities of spillover in a Canada-U.S. free trade area.

The Spillover Hypothesis

Among opponents of free trade, the most representative arguments may be found in Mitchell Sharp's 1972 document, "Canada-U.S. Relations: Options for the Future." It was in fact the hypothesis of economic, political, and cultural spillover that led to the 1972 rejection of the Second Option as a possible alternative for our foreign policy toward the United States, despite the fact that it could have been rational in terms of economic benefits. Mitchell Sharp's document illustrates the hypothesis very well, as can be seen from the following lengthy quotation:

The option spans a considerable range of possibilities. At the lower end of the scale, it might involve no more than the pursuit of sectoral or other limited arrangement with the United States based on an assessment of mutual interest. . . . This more limited form of integration has a certain logic to it and, indeed, warrants careful examination. It may be expected, however, to generate pressures for more and more continental arrangements of this kind that would be increasingly difficult to resist. . . .

A free-trade area or a customs union arrangement with the United States would, to all intents and purposes, be irreversible for Canada once embarked upon. . . . This option has been rejected in the past because it was judged to be inconsistent with Canada's desire to preserve a maximum degree of independence, not because it lacked economic sense in terms of Canadian living standards and the stability of the Canadian economy. A free-trade area permits greater freedom than a customs or economic union. . . . Yet it must be accepted that the integration of the Canadian and U.S. economies would proceed apace and we should be bound to be more affected than ever by decisions taken in Washington with only limited and indirect means of influencing them. . . .

The experience of free-trade areas (such as the European Free Trade Association) suggests, in any case, that they tend to evolve toward more organic arrangement and the harmonization of internal economic policies.

More specifically, they tend toward a full customs and economic union as a matter of internal logic. A Canada–U.S. free-trade area would be almost certain to do likewise. . . . To compete, we would probably require some harmonization of social and economic costs. . . . The only really safe way to guard against reversal and to obtain essential safeguards for Canadian industry and other Canadian economic interests might be to move to some form of political union at the same time. . . . The Europeans, it could be argued, have, after all, found it possible to operate a customs union without substantial derogations from their sovereignty. . . .

The European countries are more recognizably different from one another; their identities are older and more deeply anchored; and they are much more nearly equal in resources and power. There is a certain balance in the decision-making system, the European Economic Community, that would not be conceivable in a bilateral Canada–U.S. arrangement. For the Europeans, moreover, the problem has been one of transcending historical conflicts. For Canada, on the contrary, the problem has been one of asserting its separate identity and developing its character distinctive from that of the United States in the face of similarities, affinities and a whole host of common denominators.⁴⁵

As these extracts demonstrate, this version of the spillover hypothesis and its underlying assumptions are indeed very general, with vague comparative reference and with no real demonstration of the key points. Moreover, no one has ever gone any deeper in presenting the spillover argument.

A schematic presentation of the argument is given in Figure 2-3.

The line of argument underlying the hypothesis in Figure 2-3 may be summarized as follows:

H1a Proliferation of sectoral agreements due to:

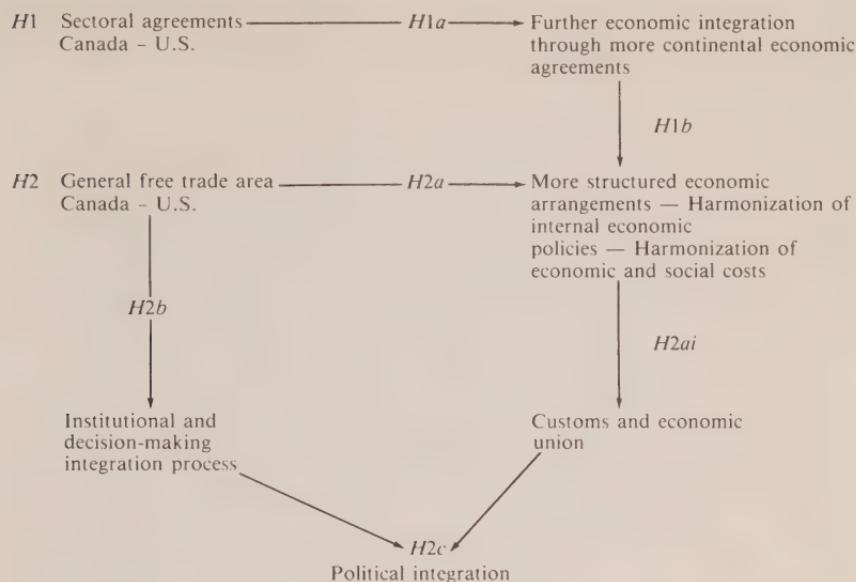
- pressure from certain quarters (economic, for instance) in the United States to extend existing sectoral agreements to other sectors that are of interest to them, thus providing them with clear benefits; and
- the need for complementarity in all factors of production, and in the economy in general, which ought not to be allowed to become too fragmented through long-term sectoral free trade.

H1b, H2a, H2ai Constant widening of economic integration due to:

- the comparative argument that is believed to follow from the integrating evolution of free trade agreements, especially in Europe;
- evolution linked to an internal logic, i.e., the functional linkage of tasks and the need for corrective and complementary free trade policies; and
- the need to harmonize socioeconomic costs to meet American competition in the area.

H2b Having joint economic policies would require a number of common

FIGURE 2–3 The Spillover Hypothesis



institutions and would also lead to a loss of decision-making autonomy (which itself is a process of political integration) because of:

- the asymmetry in the size of the two partners, which would expose Canada to ever-increasing political influence from decisions made in Washington and hence to de facto U.S. leadership; and
- the need to guarantee the irreversibility of the free trade integration process and to protect Canadian economic interests by means of a transfer of power to a joint Canada–U.S. decision-making apparatus.

H2c Institutional and decision-making integration (*H2b*) and economic integration (*H2ai*) would deprive Canada of autonomous policy power, thus leading toward political integration.

The Position Rejecting the Spillover Thesis

Turning now to the defenders of free trade, we find virtually the opposite argument, which basically limits itself to an overall general refutation of the spillover thesis. The defenders also call upon the comparative example and on an internal logic — but a logic that is diametrically opposed to the previous one; and like those opposed to free trade, they do not go beyond specious generalization.

The most typical statement of this type of argument is the position put

forward by our Senate standing committee on foreign affairs, which in 1982⁴⁶ reformulated some of its own earlier arguments or those of others (such as Peyton Lyon,⁴⁷ who was adamant that spillover was impossible). The Senate committee rejected the claim that a Canada-U.S. free trade agreement would produce economic and political spillover. The following quotations from the report illustrate its position:

Free trade areas do not tend to become customs unions; they do not become politically integrated. . . . Moreover, even countries which have organized into the much more tightly structured arrangement of a customs union or a common market, with the expressed aim of some degree of political integration, have met with frustration and difficulties in achieving their aim. Some scholars even argue that economic integration may impede political integration. . . . A shared market between the two countries would help strengthen Canadian national feeling and reduce regional tensions.

Contrary to the popular myth, it is precisely a free trade arrangement which could give Canada a lessening of this kind of constraint. . . . Is there not more basis for saying that an improved economic situation resulting from a successful bilateral free trade arrangement would give Canadians more confidence, more strength to resist pulls from the United States? . . . It has been, after all, the Canadian tariff which has resulted in the high degree of U.S. ownership in Canada's manufacturing sector and the creation of branch plant companies. Had free trade been adopted much earlier, the story could have been quite different. . . . The balance of evidence was that the two countries' taxation and fiscal policies could remain as they were. . . . Relatively little policy harmonization has been required in EFTA or in other free trade areas. . . . Even within the Community itself, which as a common market, not a free trade area, has sought policy harmonization, there is not a high degree of uniformity. That free trade is not dependent on taxation conformity is evident from the differing tax systems within the individual states of the United States. . . .

As to whether bilateral free trade would diminish the independence of Canadian foreign policy, it must first be noted that Canada's present foreign policy formulation is constrained, as is that of all the countries of the western industrialized world, by their existing economic and military interdependence. As one witness said, existing precedents do not lend support to those who fear a diminished independence. Under a free trade agreement Swedish foreign policy has been quite different from that of other EFTA members for example. . . . On the contrary, a persuasive case can be made that, if a formal bilateral free trade agreement strengthens the Canadian economy, Canada's ability to pursue an independent foreign policy would be strengthened, not weakened.⁴⁸

These selected passages, which show just how general are the considerations of the committee, are underlined by a hypothesis and argument discounting the likelihood of economic or political spillover from a Canada-U.S. free trade area.

SCHEMATIC PRESENTATION

For clarity, we give below a schematic presentation of the hypotheses discounting the possibility of a spillover, together with their supporting arguments. The hypotheses are as follows:

- H1* Canada–U.S. free trade would involve only a limited harmonization of economic policies. Thus, it would not lead to economic integration — or, consequently, to political integration.
- H2* Canada–U.S. free trade would not reduce Canada's independence in foreign policy; on the contrary, it might even increase it.
- H3* Canada–U.S. free trade would shelter Canada from tariff and non-tariff barriers imposed unilaterally by the United States. Moreover, it would discourage Canadian firms from moving to the United States in cases when such relocation is undertaken in order to get around U.S. tariff and non-tariff barriers.
- H4* Canada–U.S. free trade would not lead to political integration with the United States. It would strengthen the Canadian economy and, by extension, would strengthen Canada's national spirit and cultural identity, which in turn would increase Canada's ability to withstand the attractions of the United States and would thus protect its political independence.⁴⁹

The arguments underlying this rejection of the possibility of spillover are as follows:

- Comparison is made with the experience of other international free trade areas, customs unions, common markets, etc. According to the committee, the experiences of EFTA and NAFTA have not led to economic spillover, and the EC is still far from being the economic and political union that was initially envisaged.
- Certain form of continentalism that already exist in Canada–U.S. relations (e.g., interpenetration in terms of American investment; considerable ownership and control of Canada's resources, trade, and economy) have not led to increased economic integration involving common policies or common foreign policy. Nor have they led to cultural and political integration.
- Under a system of Canada–U.S. free trade, there is the hope of increased and more harmonious economic development in Canada, especially with regard to the western and Atlantic provinces. This would strengthen Canada's horizontal cohesiveness (between regions), as well as its economic, cultural, and political independence and its international importance.
- Another argument is based on the idea that integrating pressures could take the form of a serious threat to Canada, which would heighten national feeling.

Our Criticisms Regarding the Debate on Spillover

Our summary of the two opposed theses on the possibility of spillover resulting from a Canada-U.S. free trade area suggests a few general criticisms, as well as more specific comments on the weakness of both positions.

GENERAL COMMENTS

The most immediately striking thing about the debate is the lack of a thorough articulation of the two main theoretical positions on the question of spillover namely, (the neofunctionalist and "dirigist" approaches) or even a clear statement of premises.

In fact, although they do not clearly say so, the authors of the Third Option paper we have just referred to, as well as other proponents of the same arguments, are in the dirigist camp with respect to the study of international economic integration, which considers that liberalizing trade through free trade areas and customs unions, for example, makes it necessary to establish a number of joint or harmonized economic policy measures in order to offset negative integration and to replace it with more advanced stages of positive integration. Thus, this is left generally implicit, with greater use being made of the comparative argument than of a thoroughgoing presentation of the premises of this theoretical approach (dirigist) which, along with neofunctionalism, is the only theoretical framework able to shed light on the economic logic of spillover. Moreover, in support of their argument, they give no specific and regular references to the neofunctionalist theory of spillover — a theory that has helped to deepen our overall understanding of the process.

The same may be said of the opponents of the spillover thesis. Basing themselves on the liberal approach to international economic integration that is reflected in the theory of customs unions, they reject the possibility of spillover on the basis of very general comparative considerations, without making any attempt to provide themselves with an appropriate theoretical framework. They also postulate that free trade integration would run smoothly, despite the asymmetry of the partners, and do not see the need to have recourse to any corrective common economic policies.

To summarize, what is surprising is the absence of any attempt to make theoretical or empirical use of the various spillover theories. Although these theories may not yet be fully developed, they remain the only available theoretical framework to provide a thoroughgoing analysis of the question of the possible development of a Canada-U.S. free trade area along an integration continuum which runs from negative

economic integration to positive economic integration, and which potentially ends in political integration.

As we shall see later, we do not wish to imply that using the dirigist or the neofunctionalist theory would necessarily be sufficient to clarify the debate; there are major weaknesses in such theories as they apply to spillover. But since these theories provide the only available framework for the study of spillover, they should at least be used and developed further in order to provide a more adequate analysis of the matter and also to break out of the overly general, intuitive, and roughly comparative arguments that are currently being put forward without sufficient theoretical foundation. It should also be pointed out that the two theories need to be combined, in order to see how they might complement one another in establishing a wider range of variables in the neofunctionalist and dirigist approaches.

SPECIFIC CRITICISMS

The following are some specific criticisms concerning the debate on the economic and political spillover which might result from establishing a Canada-U.S. free trade area.

- Those debating the merits of free trade do not raise the question of whether the proposed Canada-U.S. free trade arrangement is comparable to other free trade areas.
- In the absence of any systematic analysis of these other areas, proponents and detractors are able to claim diametrically opposite conclusions, based on exactly the same cases. One camp draws on the EFTA and the Common Market in order to reject the possibility of spillover, while the other draws on them in order to support it.
- Those who claim that there is no evidence of spillover in free trade associations disregard the facts. For example, if we look at NAFTA, we can see that it did indeed lead to spillover, in the sense that it led to closer economic relations under the agreement that succeeded it in 1983, ANZCERTA, and this both broadened and deepened the free trade arrangement. The same is true of the EFTA, which led, among other things, to spillover in the form of the elimination of some non-tariff barriers, the establishment of policy harmonization in certain areas, and greater institutional development.
- The same types of error are found in connection with the European Communities (EC); those arguing against spillover appear to have a very restrictive view of the EC's development, and they ignore or discount the evidence of spillover.
- The same people flirt, through a contradictory argument, with two interpretations that are difficult to reconcile. They reject the pos-

sibility of spillover while at the same time admitting that Canada, even without free trade with the United States, has gradually become increasingly dependent on the United States in an interacting, informal, and transnational (relational and structural) spillover movement.

- The concept of spillover is not defined in a conceptually rigorous fashion. People appear to refer to it only at the institutional and policy levels, without paying enough attention to infrastructure spillover, which is already underway and which could well accelerate if a free trade area were to be established. But even at the policy level, there is a clear trend (as part of the spillover process) in the Canada-U.S. relationship toward an increasingly stultified Canadian decision-making capacity. This is the result of our heightened structural dependence on the United States in economic matters, and it demonstrates our need to wait and see what the American policy and economic situations will be so that we can align ourselves passively with them.

Our Proposals for a Theoretical Spillover Framework Suited to the Canada-U.S. Relationship

In view of the empirical, methodological, and theoretical weaknesses that we have just identified, we shall now present an outline for some tables of variables that will explain the spillover mechanisms and will allow us to deal with the question of what degree of economic and political spillover is to be expected from the development of a Canada-U.S. free trade area.

In setting these forth, we shall draw on the two mainstream spillover theories in the area of international integration: the dirigist approach and the neofunctionalist approach. We shall begin with an outline of their basic arguments and shall then put forward our own table of variables to explain the overall process and to summarize our own theoretical position.

THE DIRIGIST APPROACH

According to the dirigist approach,⁵⁰ negative integration — which eliminates trade barriers and, in some cases, barriers to the movement of factors of production — generates disturbances and distortions in a country's economy if, as is usually the case, there is economic asymmetry within the partners' respective societies (regional imbalances, for example) and between the partners (asymmetry in the development and distribution of factors of production; structural and relational asymmetry, as evidenced in interaction of the economies of member countries, etc.). This is because, in effect, the partial or total freeing up of the circulation of goods and, in more advanced integration, in the movement of the factors of production, reinforces the initial development

imbalances and causes economic distortions whose socioeconomic and political impact will call for joint corrective action (spillover toward positive integration); or, if there is no consensus for integration, will lead to the adoption of a national positions that will compromise the free trade arrangement itself (spillback).

If there is asymmetry between the partners, negative integration is thus forced to go forward, simply to avoid going backward; and spillover toward positive integration must be accepted if the arrangement is not to disintegrate into national unilateral actions.

The concept of corrective spillover resembles the neofunctionalists' idea of the functional linkage of tasks. Each new integration phase (spillover) is considered as the answer to the problems of the immediately preceding phase, and as a desirable or necessary complement to previous integration measures.

In order to clarify the process of functional and corrective spillover, Table 2-11 sets forth a list of independent variables which, according to integrative internal logic within the framework of the above-described aspects of asymmetry, suggest the progression from one integration phase to the next; this list of variables clearly has a place for the proposed Canada-U.S. arrangement. It should of course be pointed out that this table makes no claim to reflect an absolute determinism in such matters; rather, it is expressed in terms of conditions favourable to a spillover process in the continuum that includes the many forms of international integration. The limited number of cases for comparison, as well as their dissimilarity and our inadequate knowledge of the internal structure and scale of the integrative variables, make it impossible for us to construct a strongly deterministic model. We must therefore limit ourselves to a simple model of probabilities.

Table 2-11 shows that for a Canada-U.S. free trade area, a number of conditions favourable to integrating spillover exist, although the methodological considerations mentioned prevent them from being the necessary and sufficient conditions of a deterministic model.

First of all, there are several technical problems in operating a Canada-U.S. free trade area. The long Canada-U.S. border and the qualitative and quantitative enormity of the intracontinental (often intra-firm) and external trade of the two partners would make controlling the origin of goods and the value-added component very difficult if trade diversion effects were to be prevented. This is the reason for the strong pressure to create a customs union, which at this level appears to be a way of simplifying free trade mechanisms. Nevertheless, we admit that the United States, being an economic superpower, would not want common tariff and non-tariff policies with Canada vis-à-vis the rest of the world — hence the forecast of disintegration pressures.

Access to the markets of both countries, especially access of Canadian products to American markets, would not always be, in economic

TABLE 2-11 The Shortcomings and Requirements of Each Form of Asymmetrical Economic Integration Likely to Give Rise to a Spillover Process

Integration Shortcomings and Requirements	Form of Integration ^a				
	Free Trade Area	Customs Union	Common Market	Economic Union	Full Economic Union
Unwieldy and complex to operate without common external tariff, e.g., control over trade diversion calculation of value added	x				
Problems pertaining to the lack of common tariff and non-tariff policies toward other countries	x				
Distortions and other disturbances of trade, as well as of general socioeconomic conditions, which may be due to the fact that not all the factors of production are able to move freely		x			
Distortions and other disturbances of trade, as well as of general socioeconomic conditions, due to the absence of harmonized or common policies to correct irregularities in the free movement of factors of production or to complement a prior integration phase	x	x		(x) ^b	(x) ^b
Problems relating to the absence of strong common institutions (supranational)	x	x		(x) ^c	(x) ^c

a. We consider that each integration stage in the continuum includes features of the previous one.

b. A common market or a partial economic union cannot include all harmonized or common policies needed to combat the distortions: hence our parentheses (otherwise they would be a full economic union).

c. A common market or a partial economic union could not always operate according to a strong institutional model (supranational) and could content itself (primarily for political reasons) with weak intergovernmental institutions (everything depends on the extent of the harmonized or common policies in the partial economic union); hence our brackets. On the other hand, full economic union needs these sorts of institution if all economic aspects are completely integrated.

terms, preferential in comparison with third countries. Such a situation might arise if either Canada or the United States, through a low customs tariff policy and non-tariff liberalism, allowed products from other countries (e.g., the newly industrialized countries) to remain competitive in the area even after customs duties were paid, especially if the cost of production in these outside countries was low compared to the cost of production in the countries of the free trade area. Here, also, moving toward a customs union would be desirable.

The establishment of a customs union could lead to a common external trade policy, in order to include tariff policies and to go beyond them.

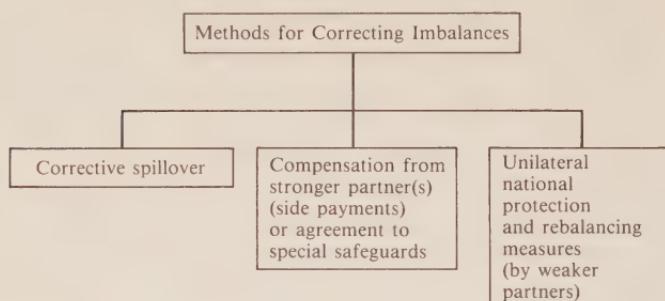
However, a customs union would not solve problems of asymmetry in the factors of production, because the absence of free movement at this level would favour the stronger partner (the United States), with its greater factor of production potential centred in its regions and with the poles of economic development giving it a clear advantage. The establishment of a common market, liberalizing all the factors of production, would appear to be an initial response to this asymmetrical concentration — on condition that a number of policy incentives be added.

The United States has several economic centres which, because of their concentration of factors of production, are poles of development for Canadian regions. For instance, the states of New York, Pennsylvania, and Illinois may be considered sales territories for the output of central Canada, as well as the headquarters of parent companies; the American West plays the same role for the resources of western Canada, as well as being a centre of expertise for resource industry exploration, etc. Consequently, free trade, or the liberalization of all the factors of production, would contribute to entrenching the imbalances in the production process and would distort the free circulation of goods and factors of production, thus strengthening the competitive position of the stronger partner. Harmonized or common corrective policies will therefore be essential if the partners are to avoid national protectionism and rebalancing unilateral interventions that would threaten to disturb free trade, would irritate the United States, and would give rise to disintegrating forces. This harmonization would need to include economic and production cost policies, social policy, fiscal policy, monetary policy, transportation policy, competition policy, industrial policy, regional policy, etc.

The need for proportion between the degree of integration of the economic infrastructure and policies and the legal-institutional superstructure would lead, in the case of corrective economic spillover, to the establishment of an effective legal-institutional framework for the essential harmonized or common policies mentioned above.

Canadian proponents of Canada-U.S. free trade recognize the need for measures to correct the distortions that would result from liberalizing trade between two unequal partners, but they always put forward national

FIGURE 2-4 Integration in an Asymmetrical Interdependence Relationship



remedies in the form of unilateral Canadian corrective policies, which the Americans would certainly, and probably quite rightly, reject as non-tariff barriers and as economic interventionism that would be inimical to their economic philosophy and to free trade and continentalism.

In view of these imbalances, corrective spillover and the disintegration of unilateralism are, of course, not the only two options. In an asymmetrical relationship, there is a third alternative in the form of compensation by the stronger partner to the weaker partner (see, for example, the concessions agreed to in a spirit of compensation by West Germany in the EC framework). Thus, taking as our starting point P. Taylor's proposal,⁵¹ we believe that asymmetrical interdependence would cause the international integration framework pendulum (free trade integration, for example) to swing between three different positions, as illustrated in Figure 2-4.

THE NEOFUNCTIONALIST APPROACH

Neofunctionalism is the approach that has gone furthest in presenting a spillover theory; it also includes all phases of the integrating continuum, which includes an economic and political spillover process.

The work of Haas and others who have considered the question of the evolution of international integration includes the theory of a spillover initially viewed as a functional mechanism, a spontaneous spillover process based on a functional linkage of tasks; it is later considered as "cultivated" spillover, in which only a major political intervention is likely to be able to move integration toward the advanced stages of the process. Other neofunctionalists, such as Nye,⁵² have put forward other concepts to explain the integrative spillover process. Nye points, among other things, to externalization, rising transactions, coalition formation, elite socialization, regional group formation, and ideological-identitive appeal.

From among the main independent variables that could account for the spillover process, or at least be considered favourable to it, Haas and the neofunctionalists,⁵³ complemented by the dirigist approach, could well point to the following variables: the permanence of significant "background conditions" that are significant in number and in terms of degree; the fact that elites are especially susceptible to acting according to a bureaucratic model, which makes them particularly sensitive to technocratic rationalization of integrating processes and which thus prevents such matters from becoming politicized and made ideological; the development of transnational relations which depoliticize relations between partners; the integration reaching a ceiling; operating irregularities and unequal distribution of benefits in the integrated area; the absence or decrease of alternative solutions, which encourages continued development of the integrating process; externalization of the integrating process (the need to establish relations with other countries, which either is seen to be necessary by members of the union or is generated by requests from the outside countries); the need for a functional linkage of tasks if new policies are to be added (complementary, in this case, rather than corrective of free trade); continuity between matters of low politics and those of high politics; the prior establishment of strong common institutions; the political desire for spillover.

Even with all these variables, it is difficult to forecast the launching of a spillover process with any certainty; since the weights of the various variables have not been identified or their internal structure explained, they are still measured mainly qualitatively (one speaks in terms of low, average, or high probability, for example), and it remains impossible to speak of "necessary" and "sufficient" conditions for spillover.

Our use of Table 2-12 to measure the likelihood of spillover for a proposed future Canada-U.S. free trade area does not therefore allow us to make predictions with certainty; instead, we give an overall evaluation of the probabilities of economic and political spillover for the area.

OUR EVALUATION OF THE LIKELIHOOD OF SPILLOVER

In Table 2-12 we identify neofunctionalist variables, occasionally reformulating them in the light of the dirigist approach. In view of the reservations mentioned above, it goes without saying that it is not at all clear that all the variables given in the table need to be present for spillover to occur; or, even if they are, that they would be sufficient to cause spillover.

A brief explanation of the variables in this table is in order. First of all, a quantitatively and qualitatively significant initial integrative potential is needed to link the two countries, as explained earlier. Consider, for example, the average-to-high integrative conditions which mark Canada-U.S. relations and which leave open the possibility of free trade

**TABLE 2-12 Overall Evaluation of Probability of Integrative Spillover
in the Eventuality of Canada-U.S. Free Trade
(favourable conditions)**

Conditions Favourable to Spillover	Evaluation of Condition
1. Presence, continuance, and development of initial quantitatively and qualitatively significant integrative potential conditions	average-high
2. Predominance in both member countries of a bureaucratic model	average
3. Increased development of transnational (and perhaps transgovernmental) relations	high
4. Free trade area's integrative results reach a ceiling	high
5. Operating irregularities, trade distortions, economic disturbances, and unequal distribution of benefits in the free trade area that are impossible to correct by means of unilateral compensation or unilateral measures	high
6. Functional linkage of tasks, due to the need to adopt new policies to complement free trade policies	average
7. Absence or discounting of alternative solutions	average-high
8. Externalization of the process	average
9. Continuity between matters of low politics and high politics	low
10. Establishment at the outset of strong common institutions or the need and desire to do so later	low
11. Political will for cultivated spillover (mainly on the part of élites, but also the general public)	low

integrating arrangements (see the CUFTA column of Table 2-9). If these conditions were to continue after integration, as seems likely, they could lead to further integration and hence to spillover. According to Table 2-9, the potential for such a situation is high. This reinforces the probability of spillover.

The process of de-ideologicization and depoliticization that advanced industrial societies are going through, accompanied by economic and technological determinism on the one hand and by technocratic and bureaucratic legitimacy on the other, could foster a spillover involving rationalization of Canada-U.S. relations. However, in view of the enormous domestic and international power of the United States, the fear of

Canada's political absorption by the United States — and the accompanying nationalistic feelings — often causes American and Canadian leaders to take politicized or even ideological positions (see, for example, the stances taken by Diefenbaker and Trudeau on domestic and international matters). Thus, in certain instances, they even play the role of dramatic political actors, without identifying with it completely or permanently, producing the average evaluation of the second variable found in Table 2-12 (an overall evaluation whose intensity cannot be rated any more accurately).

A major transnationalization of Canada-U.S. relations (companies, unions, etc.) could lead to an integrative spillover. Intrafirm relations, for example, usually avoid government politicization and establish strong integrative infrastructures which draw Canada increasingly into the north-south orbit. In terms of comparison, the evaluation of this variable for the Canada-U.S. situation appears to be higher than for other integration frameworks such as EFTA and NAFTA/ANZCERTA (see Table 2-9).

As comparative experience in international integration shows, free trade areas have a great deal of difficulty in broadening their field of integration. Consider the position of a Canada-U.S. free trade area, caught up as it would be in intergovernmental inertia, exposed to unilateral intervention by one or other of the partners; struggling with the question of non-tariff barriers, special exempting, and trade diversion; unable to deal with the problem of asymmetrical distribution of the benefits of integration; annoying the United States by non-intervention in cases of Canadian protectionism and annoying Canada by its economic distortions; and fragmented in its interaction with the international environment, in the absence of a customs union. Would this free trade area show signs of running out of steam and reaching a ceiling, in terms of utility, to the point that it would have to choose between disintegrating stagnation and developmental spillover? The example of NAFTA, which spilled over into the new 1983 ANZCERTA agreement, extending free trade and tightening economic links between the two countries, is conclusive. The same is true of EFTA's need to evolve; some of its members sought change through membership in the EC and others through a free trade link with it.

As we have already mentioned, asymmetry between the partners in a Canada-U.S. free trade arrangement would definitely make Canada extremely vulnerable in many ways, and this would call for corrective and complementary measures for the area if unilateral action with disintegrating effects was to be prevented. The only alternative would be for the stronger partner to agree to compensation or special measures and safeguards.

The same is true of the question of functional linkage requirements, which we looked at earlier.

Canadians would have strong feelings of irreversibility because of the

modernizing, specializing, and remodelling of the Canadian economy that would take place within a framework of economies of scale in a free trade area of two partners; because of the dissatisfaction of other countries with such regional protectionism; and because of the failure of the Canadian Third Option policy, leading to this form of continentalist policy. The absence of alternative solutions would lead to greater acceptance of continentalist integrating logic and therefore to an inability to hold back the spillover. We, however, evaluated this variable as "average to high" rather than "high," because the lack of alternative solutions is of more concern to Canada than the United States (less restructuring of the latter's economy would be required by free trade and, since it is an international superpower, its choices would be less compromised).

The following must also be considered: the need to respond to the criticisms and the requests for arrangements of countries that will be faced with this regional free trade arrangement; the need to contribute in a coordinated manner to multilateral debate on trade liberalization; the need to ensure, through common trade policies, that there will be clear benefits in the market of the other partner vis-à-vis other countries; the increased internationalization of the economies of advanced industrialized societies and the increasing structuring of the world economy. All these conditions suggest a high probability of externalization of the Canada-U.S. free trade area, which could constitute a sufficient cause of spillover toward a customs union and common trade policies. Our evaluation of this variable as "average" is due to the probability of American reticence toward common policies.

On the other hand, the continuity between matters of low policy and matters of high policy is by no means certain in the Canada-U.S. situation (low variable). Continuity would be reduced to a very low level by the following factors: the desire to maintain Canada's cultural and political identity; the heightening of the Canadian people's historical and political awareness of the risks of political absorption; the political fragmentation of the Canadian federal system; the strength of the United States as a superpower; and the desire of Americans to keep a free hand in the sphere of diplomacy and strategy. Henceforth, the area's political spillover could not be the result of a functional linkage of tasks, but rather of a long process of Canadian economic dependency and institutional penetration in a context of growing economic integration.

At the institutional level, it has been observed that strong common institutions can be a driving force toward integrating spillover. Speaking of the establishment of the supranational European Community, the byword was "The institutional first, economics and politics later." However, we saw in earlier sections that the institutions of a Canada-U.S. free trade area would most likely be weak, i.e., intergovernmental, and this would not in itself favour a progression toward integration. Nev-

ertheless, one might expect that the rule of proportionality between integrated matters and institutions might well lead to a strengthening of institutions when policies to correct free trade distortions and problems are implemented; this in turn could accentuate the economic and political spillover process (although, under certain conditions, a new package of policies could be implemented by the intergovernmental institutions without any substantial institutional spillover).

The political determination, not only of elites but of the general public, that would be needed for political spillover does not appear to us to be present in the current context of Canada-U.S. free trade. On the Canadian side especially, there is a manifestation of strong opposition to the idea of political integration with the United States, even though an economic spillover might lead to political integration.

FINAL CONSIDERATIONS ON SPILLOVER

To conclude, after this explanation of Table 2-12, we shall now make a few general comments on our evaluation procedure and on the conclusions which might be drawn from the table.

First, it is clear that evaluating the intensity of the variables of the table into categories of "high," "average," or "low" is complicated by the fact that they are not exactly the same in both countries. For example, points 7 and 8 are judged to be of higher intensity in Canada than in the United States; this complicates the common rating given for both countries taken together.

Second, what overall conclusions can be drawn from the table? We see a potential for integrating spillover, with three conditions of high intensity, two of average to high, three of average, and only three of low. Even though the high or average variables are primarily in the economic area (economic spillover), one cannot fail to see the possibility of dynamic linkages toward spillover in institutional and political decision-making, through common, corrective, and complementary free trade economic policies which call for abandoning certain sovereign powers for unilateral action. The cases that would restrain this political spillover (apart, of course, from the disintegration of the free trade association) are an intergovernmental framework for economic policy and a unilateral system of compensations (side payments) to Canada by the United States; yet these are the two least satisfactory solutions from the point of view of rationalizing integration.

Third, the methodological problems of forecasting spillover also bear repeating. The impossibility of quantifying the variables in Table 2-12, as well as the problems of weighting and ranking them, are obstacles to a more rigorous forecasting system; so there is an uncertainty about how the variables would interact, and the impossibility of expressing predictions in terms of "necessary and sufficient conditions." Since we are

concerned here primarily with policy and institutional spillover, the various other forms of infrastructural spillover, which are well underway, cannot be excluded.

To conclude, we wish to emphasize that a spillover process does not exclude crisis situations, and which could nevertheless contribute to the progression of integration. To recall what Haas said on the subject, if it is true that "the process of spillover from economic integration will not only lead to gradual politicization, but also to occasional crises,"⁵⁴ it is equally true that "crisis is the creative opportunity for realizing the potential to redefine aims at a higher level of consensus."⁵⁵

General Conclusions

In this type of study, it is very difficult to come to general conclusions. There are various reasons for this:

- The volume and complexity of the material dealt with and the analytical tools used do not lend themselves to simple summaries. Any attempt to produce such summaries would run the risk of oversimplification.
- The sheer volume of this paper does not require us to make it more cumbersome by adding a section dealing with conclusions.
- The uncertainties with respect to content, framework, modes, etc., of the Canada-U.S. free trade scenario (the perspective taken in this analysis) reduce the possibility of drawing pertinent conclusions.
- Because of the strongly nuanced and often exhaustive nature of the themes developed in this paper, it would be all too easy to oversimplify the issues in a concluding section.
- The multidisciplinary and multidimensional aspect of the paper also makes it difficult to form firm conclusions.
- The need for a conclusion is lessened by the fact that the tables and figures do provide a synthesis.

Nevertheless, taking the policy-oriented concerns of the Commission into consideration, we thought we should formulate a few general conclusions.

The Need for a Dynamic and Diversified Conceptual Framework

- An understanding of the complexities of a Canada-U.S. free trade area leads to a conceptual framework which places the project in its fundamental conceptual environment. Thus, free trade could be understood as a foreign policy option, an essential form of continentalism, and an initial stage in the integrative continuum of international regional integration.

- Far from being a form of unidimensional integration, free trade opens up a wide range of possibilities. These are defined in ten pairs or trinomials, in Table 2-3.
- Since free trade involves the removal of trade barriers of a multi-faceted nature, it requires a diversified conceptual framework. This has prompted our preference for the EC's fourfold classification (customs duties, quantitative restrictions, and measures equivalent in their effects to quantitative restrictions) rather than a binary division into tariff and non-tariff barriers.
- Since free trade is not only a legal framework for the free circulation of goods but also an economic reality, we have examined related dysfunctional phenomena such as trade distortion and the creation and diversion of trade.

The Foreign Policy Debate: Some Elements of Orientation

- It is impossible to grasp the essence and complexity of the free trade option without placing it in the context of the historical, political, sociocultural, economic, and geographical environment that underlies Canada's hesitancy about forming a free trade area with the United States. We have always found it difficult to give up our transatlantic diversification and certain elements of our national identity in order to establish continentalist ties; however, it is becoming increasingly doubtful that diversification will be able to provide for Canada's market needs or its economic restructuring during the last two decades of this century.
- The attitudes and decisions relating to free trade option in North America have been determined by considerations which partly avoid the economic and technological determinism of our times, interposing a cultural and political dimension.
- Canada is constantly being pulled along in the wake of continentalism, since it is the only advanced industrial society that does not have an internal demographic reservoir, or a multilateral or bilateral (but symmetrical and diversified) regional integration framework.
- In the present decade, a number of factors have combined to make it increasingly difficult for Canada to resist the free trade continentalist option. These factors include protectionist moves in the United States using non-tariff barriers, Canada's acceptance of GATT's deregulation of tariffs, its existing involvement in transnational and transregional continentalism, its awareness of the serious limits to its efforts at international diversification, and its need to restructure its economy.
- In considering the economic imperative pushing Canada toward free trade, we should not exclude the fact that under certain conditions a springboard to diversification could be found (reinforcement, through

cooperation with the United States, of the international importance of our economy); however, through a feedback phenomenon, Canada could profit from such a diversification and be competitive in a North American free trade. Diversification and continentalism could thus become compatible.

The Perceived Content and Institutional Framework of Free Trade

- If the continentalist option of sectoral free trade (rather improbable) were accepted, it would be essential to allow for "linkage" and package deals, so that both partners can be accommodated in the selection of the sectors to be involved in the free trade arrangement.
- The most probable option of a general free trade would be of a bilateral and imperfect nature (imperfect in that certain non-tariff barriers, especially Canadian ones, could be maintained); it would involve partial reciprocity; and it would be automatic, gradual, evolutionary, asymmetrical, and have a low degree of institutionalization.
- Without common supranational institutions, particularly a court of justice, the initial and ultimate definition of non-tariff barriers will be difficult — as will be the task of suppressing them. Such an institution should be a Canadian priority, and it should get its inspiration from the EC, particularly in regard to EC law conceptualization of "measures equivalent in their effects to quantitative restrictions."
- There is a strong likelihood that the United States will consider that certain important sectors of Canadian socioeconomic policy (such as regional policies, industrial restructuring, and aids to exports) are non-tariff barriers. This will present thorny problems during the Canada–U.S. free trade negotiations, which will have to make allowances for the asymmetry of the partners and for Canada's need to maintain (and, in certain cases, reinforce) its national policies in order to make adjustments for Canadian disparities.
- In the absence of a customs union, Canada–U.S. free trade will run the risk of being dysfunctional (trade distortions, trade diversions) and of being costly at the administrative and operational level (because of the need to provide certificates of origin, to determine the value-added percentage necessary for the free circulation of goods, etc.).
- The asymmetry of the partners calls for common socioeconomic policies, which will guarantee that there really is a free circulation of goods (in terms of economic reality and not simply in legal terms) and which will rectify the asymmetrical movement of factors of production, along with their socioeconomic and political costs.
- From an institutional point of view, the principle of proportionality and the national susceptibilities of the two partners will allow for a

limited number of common institutions; these would be predominantly administrative and technocratic institutions, composed of two national delegations, based on the principles of parity, and rather weak (with limited powers and with the decision-making process being based on unanimity). However, the need to avoid "decision-making paralysis" and to encourage a corrective *spillover* in the form of common economic policies has thus led us to propose an institutional model that lies halfway between classic intergovernmentalism and supranationalism. In this model, the intergovernmental institutions would be politico-administrative in nature, large in number, and not always based on parity in their composition, and they would have the power to formulate common policies in order to correct asymmetries and distortions in Canada-U.S. free trade.

The Comparative Experience of International Regional Integration

- In the specialized literature on Canada-U.S. relations, the comparative analyses are limited and general in nature. Moreover, they do not always employ appropriate levels of comparison. For example, unlike CUFTA, the EFTA is not a bilateral zone; as for NAFTA/ANZCERTA, it has not been subjected to enough research or theorization to allow for valid comparisons.
- All comparisons should take account of the very particular characteristics of Canada-U.S. free trade, summarized in Tables 2-8 and 2-9, which compare the integrative potential of CUFTA with that of EFTA and NAFTA/ANZCERTA.
- Contrary to the assertions in the specialized literature on Canada-U.S. relations, EFTA and NAFTA/ANZCERTA have both experienced spillover at various levels — a limited spillover, to be sure, but a very real one nonetheless.
- One of the most interesting comparisons offered by NAFTA/ANZCERTA is that of the negotiations model. This could serve as a guide for the CUFTA negotiations if they were to be carried out on the lines suggested in this paper.

Some Orientations for Spillover

- The specialized literature on the possibility of spillover in a Canada-U.S. free trade area is normative and general in nature.
- The theory of spillover proposed in this study is based on an eclectic fusion, taking into account the dirigist and neofunctionalist approaches. In addition, our tables of variables lead to the view that a

Canada-U.S. free trade area would produce economic spillover, which would inevitably lead to a certain amount of political spillover. In an asymmetrical framework, the harmonization of economic policies would deprive the weaker partner (i.e., Canada) of real decision-making powers unless a resistance to the logic of spillover were to lead to a disintegration process with unilateral decisions and national interventions.

- The desire to halt the economic and political spillover in a Canada-U.S. free trade area (especially by having a weak institutional framework) would lead to distortions, dislocations, decisional paralysis, disintegrative tendencies, or the dynamics of absorption — often to the benefit of the stronger partner (i.e., the United States).
- Nevertheless, the low level of integration of a free trade area would reduce the extent of the integrative spillover. The movement from negative integration (free trade area) to positive integration (customs union with a common external trade policy, common market, monetary union, economic union) is more difficult. The continuity between issues of low politics and issues of high politics is not assured; the absence of strong institutions, together with the political determination of those negotiating CUFTA, will limit the amount of spillover.

Notes

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1. In this connection see: R. Tremblay, "La politique commerciale et le développement du Canada," in P. Painchaud (ed.), *Le Canada et le Québec sur la scène internationale*, 1977, especially pp. 182-86; R.D. Francis and D.B. Smith (eds.), *Readings in Canadian History: Post-Confederation*, 1982 (papers by C. Berger, G. Smith, S. Leacock and H. Bourassa); G.A. Rawlyk, "Canadian-U.S. Relations: An Historical Probe from the East," paper presented at a seminar, "University Consortium for Research on North America," Harvard University, November 1983; P. Soldatos, "La politique de diversification du Canada dans le contexte de ses relations avec les États-Unis," paper prepared for a seminar at Harvard University, "University Consortium for Research on North America," in April 1984, organized within the framework of a research project on Canadian-U.S. Relations, co-chaired and co-directed by P. Soldatos and L. Gardner Feldman. See especially pp. 41-43.
2. Mitchell Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspectives*, 1972 (referred to in Table 2-1 as the 1972 document).
3. We have in mind primarily the two following documents: Canada, Department of External Affairs, *La politique commerciale du Canada pour les années 80 - Document de travail* (Ottawa: Minister of Supply and Services Canada, 1983); *Une étude de la politique commerciale canadienne - Document d'information sur la politique commerciale du Canada pour les années 80* (Ottawa: Minister of Supply and Services Canada, 1983).

4. *Supra*, note 1.
5. On questions of fragmentation, see: I.D. Duchacek, "Transborder Regionalism and Micro-Diplomacy," paper delivered at a seminar of the "University Consortium for Research on North America," Harvard University, December 1983; E. Feldman and L. Gardner Feldman, "The Reorganization and Reconstruction of Canadian Foreign Policy," *Publius* (Fall 1983); R.H. Leach, "Central versus Provincial Authority in Making Foreign Policy for Canada," paper delivered at Harvard University, October 1981 (rev. 1982).
6. For the proponents of Canada-U.S. free trade or other forms of integration, both from the Canadian and American points of view, see the references in P. Soldatos, "Les données fondamentales du devenir de la politique étrangère canadienne" (1983), 1 *Études internationales*, Special issue, *La politique étrangère du Canada dans les années quatre-vingt*, edited by A. Donneur and P. Soldatos especially notes 21, 22, and 23.
7. See especially the government publications referred to in note 3.
8. On the debate between proponents and opponents of Canada-U.S. free trade, see especially: "Canada-United States Trade and Policy Issues," in *Canadian Public Policy* 8 (Fall 1982), special issue, supplement (especially the contributions of P. Wonnacott and R.J. Wonnacott and B.W. Wilkinson); several written briefs to the Royal Commission on the Economic Union and Development Prospects for Canada; presentations at a Commission seminar in October 1983 on Canada-U.S. free trade (see especially the papers delivered by C. Beigie, H. Eastman, R. Harris, F. Lazar, M. Watkins, B. Wilkinson, R. Wonnacott).
9. On the concept of fundamental orientations see Donneur and Soldatos, *supra*, note 6.
10. For specialist literature on various aspects of continentalism and Canada-U.S. relations, see (in addition to my references in notes 6 and 8) A. Axline, et al. (eds.), *Continental Community?*, 1974; J.S. Dickey, *Canada and the American Presence*, 1975; J. Eayrs, "Canada and the United States: The Politics of a Disparate Power," in *Centennial Review*, 1966; H.E. English, *Canada-U.S. Relations*, 1976; A. Fox, et al. (eds.), *International Organization*, special issue, 1974; R.C. Grey, *Trade Policy in the 1980's: An Agenda for Canada-US Relations*, 1981; K. Levitt, *Silent Surrender*, 1970; J.H. Redekop, "A Reinterpretation of Canada-American Relations," in *Canadian Journal of Political Science* 2 (1976): 227-43; H. von Riekhoff, et al., *Canada-US Relations*, 1979; A. Rotstein, "Independence Where the Nights Are Long," paper delivered at the "University Consortium for Research on North America," Harvard University, 1982; Soldatos, *supra*, note 6, and the references therein, especially notes 21, 22 and 23; P. Soldatos, "Quinze ans de politique étrangère canadienne," in G. Gosselin (ed.), *La politique étrangère du Canada* (Québec: Université Laval, 1984); D. Stairs, "North American Continentalism," in D. Cameron (ed.), *Regionalism and Supranationalism*; G. Stevenson, "Canadian Regionalism in Continental Perspective," *Journal of Canadian Studies* (Summer 1980): 16-28; R.F. Swanson, *Intergovernmental Perspectives on the Canada-U.S. Relationship*, 1978. See also the various studies on free trade continentalism, especially the work of P. Wonnacott, R.J. Wonnacott and B.W. Wilkinson on the question of Canada-U.S. free trade (and among their more recent studies see those published in a special issue of *Canadian Public Policy*, October 1982). See also studies by the Economic Council of Canada and the Ontario Economic Council on the same topic, as well as a number of briefs already submitted to the Royal Commission on the Economic Union and Development Prospects for Canada, including those of Senator G. van Roggen and the Canadian Institute for Economic Policy. See also the brief by Professor J.J. Quinn to the Senate Standing Committee on Foreign Affairs in June 1980. See, finally, the report developed under the auspices of the Canadian-American Committee, *A Canada-U.S. Free Trade Agreement*, 1983.
11. On this "springboard" concept, see especially: C. Pentland, "L'Option européenne du Canada dans les années 80," *Études internationales* 1 (1983), p. 1; see also Soldatos, *supra*, note 1; see also the speech on Canadian-American relations given in Winnipeg by Allan MacEachen in January 1975.
12. On world product mandates see notably: B. Perron and B. Bonin, "Les mandats

mondiaux de production," *Les Cahiers du CETA/HEC* 83-04 (1983); P.-P. Proulx, "North American Trade in a Changing International Context: The Role of World Product Mandates," paper delivered at a conference entitled "Financial Times — Corpus C.P." in Toronto, October 1981.

13. On strategies for investment of European capital in Canada see M. Azoulay, "L'Accord cadre et la coopération économique entre le Canada et les Communautés européennes," *Cahiers du CEDE*, Université de Montréal, 1979.
14. The term "negative integration" (the elimination of obstacles) is borrowed from J. Pinder, "Problems of Economic Integration," in G.E. Denton (ed.), *Economic Integration in Europe*, 1969, p. 145.
15. On this concept in European Communities law see D. Wyatt and A. Dashwood, *The Substantive Law of the EEC*, 1980, p. 77ff.
16. See, especially CJCE, Affaire 7/68, *Commission c. Italie*, Rec. 1969.
17. Aff. Jointes 2-3/62 *Commission c. Belgique*, Rec. 1962.
18. Aff. 24/68, *Commission c. Italie*, Rec. 1969 (also Aff. 2-3/69).
19. Aff. 77/72, *Capolongo c. Azienda*, Rec. 1973.
20. See, for example, aff. 63/74, *Cadskey c. Instituto Nazionale per il Commercio Estero*, Rec. 1975.
21. In addition to the following references on non-tariff barriers see also, for comparative consideration of Canada—EC, the papers in a special issue of the *Revue d'intégration européenne* (May 1980), especially the contributions of I. Bernier and J. Leavy.
22. Aff. 2/73, *Geddo c. Ente Nazionale Risi*, Rec. 1973.
23. See Directive 70/50.
24. See, for example, aff. 12/74, *Commission c. RFA*, Rec. 1975.
25. See, for example, aff. jointes 88-90/75 *Sadam c. Comitato interministeriale dei Prezzi*, Rec. 1976.
26. Aff. 8/74, *Procureur du Roi c. Dassonville*, Rec. 1974.
27. See for example, aff. 6/74, *Costa c. ENEL*, Rec. 1964.
28. *Canada—United States Relations*, vol. 3, 1982, especially pp. 14–20 and 158.
29. See the detailed typology in S. Galt, *The GATT Negotiations*, 1973–75, 1974, p. 31.
30. On EFTA non-tariff barriers, see also R. Middleton, *Negotiating on Non-Tariff Distortions of Trade: The EFTA Precedents*, 1975.
31. See, among others, J. Labrinidis, *The Structure, Function and Law of a Free Trade Area: The European Free Trade Association*, 1965.
32. B. Balassa, "Towards a Theory of Economic Integration," *Kyklos* 1 (1961): 1–12.
33. Labrinidis, *supra*, note 31, recognizes the need for proportionality, without really analyzing it.
34. On EFTA see references below, note 37.
35. On the BLEU, see Soldatos' study carried out in the framework of Belgium—Quebec Cooperation, "L'Union belgo-luxembourgeoise au lendemain de sa reconduction *Studia Diplomatica* 5 (1984): 591–635.
36. F.E. Figures, "Legal Aspects of the European Free Trade Association," *International and Comparative Law Quarterly* (October 1965), p. 1082.
37. For literature on EFTA, see: "Association européenne de libre échange," *Annuaire européen*, 1981, pp. 626–49; T.C. Archer, "Britain and Scandinavia: Their Relations with EFTA," in *Cooperation and Conflict — Nordic Journal of Integrational Politics*, 1976, pp. 1–23; F. Honegger, "L'AELE a vingt ans," *Revue économique franco-suisse*, 1980, pp. 7–9; the excellent study by Labrinidis, *supra*, note 31; the study *Building EFTA: A Free Trade Area in Europe*, prepared by the EFTA Secretariat (1968 ed.).
38. On NAFTA/ANZCERTA see: H. Gold and R. Thakur, "New Zealand and Australia: Free Trade Agreement Mark II," *World Today*, October 1982, pp. 402–10; R. Thakur and H. Gold, "The Politics of New Economic Relationship: Negotiating Free Trade Between Australia and New Zealand," *Australian Outlook* (August 1983): 82–88;

D.J. Thomas, "The GATT and the NAFTA Agreement," *Journal of Common Market Studies* (September 1976): 29–41. See also the text of the agreement establishing ANZCERTA, signed on March 28, 1983.

39. Thakur and Gold, "The Politics," *supra*, note 38, p. 85.

40. On the ANZCERTA negotiations, see notably Thakur and Gold, *ibid*. On negotiating in general, see G.R. Winham, "Negotiation as Management Process," *World Politics* (October 1977): 87–114. Table 2-10 is based on these studies.

41. On the concept of spillover in the neofunctionalist approach and on certain related problems, see especially studies by E.B. Haas: *The Uniting of Europe*, 1957; *Beyond the Nation State*, 1965; *Economics and Differential Patterns of Political Integration*; E.B. Haas and P.C. Schmitter, *The Obsolescence of Regional Integration Theory*, 1975. See also, R.D. Hansen, "Regional Integration," *World Politics* 2 (1969): 242–71; "European Integration: Forward March, Parade Rest, or Dismissed?", *International Organization* 2 (1973): 225–54.

42. On cultivated spillover, see E.B. Haas, "The Uniting of Europe and the Uniting of Latin America," *Journal of Common Market Studies* 4 (1967): 315–43, as well as the preface to the 1968 edition of his work *The Uniting of Europe*, *supra*, note 41.

43. Hass, *The Uniting of Europe*, *supra*, note 42, Preface, p. 23.

44. "Regional Intergration," *International Organization* 4 (1970): 607–46.

45. Sharp, *supra*, note 2, pp. 15–16.

46. English, *Canada–United States Relations*, vol. 3, *supra*, note 10, pp. 102–109.

47. See especially Peyton V. Lyon, *Canada–United States Free Trade and Canadian Independence*, study prepared for the Economic Council of Canada (Ottawa: Information Canada, 1975). See also his study "Second Thoughts on the Second Option," *International Journal* 4 (1975): 646–70.

48. English, *Canada–United States Relations*, *supra*, note 10, pp. 102–107.

49. On the forecast reaction see N. Black, "Absorptive Systems are Impossible: The Canadian-American Relationship as a Disparate Dyad," in A. Axline, et al. (eds.), *Continental Community?*, 1974, pp. 92–108.

50. On this approach and the opposing liberal approach see especially: K. Albrecht, *Probleme und Methoden der Wirtschaftlichen Integration*, 1951; Balassa, *supra*, note 32; H. Elsenhans, "Théories économiques pour l'étude de l'intégration européenne," in D. Lasok and P. Soldatos (eds.), *Les Communautés européennes en fonctionnement*, 1981, especially pp. 577–85 and references cited; G. Giersch, "Economic Union between Nations and the Location of Industry," *Review of Economic Studies* 3 (1949–1950): 85–92. Perroux, "Les industries motrices et la croissance d'une économie nationale," *Économie appliquée* 1 (1963): 151–96. (See also the work of this author on the concept of *development pole*); J. Viner, *The Customs Union Issue*, 1950.

51. See especially P. Taylor's study "Interdependence and Autonomy in the European Communities," *Journal of Common Market Studies* (1980): 370–87.

52. See especially J.S. Nye's study, *Peace in Parts*, 1971.

53. See especially the references to a number of works by Haas and other authors, *supra*, notes 41 and 42.

54. Quoted by Hansen, *supra*, note 41, p.244.

55. *Ibid.*



Managing Canada-U.S. Economic and Trade Relations: *Institutional Elements*

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General Features of the Relationship

The bilateral relationship between Canada and the United States has always been of unique importance to both countries. The complexity and depth of the relationship is apparent at all levels and in all sectors of society. There is continuous interaction between the two countries of an order that does not exist for either with other countries: between private citizens and friends and relatives; between universities and research groups; between members of labour unions and farm groups and a host of other associations in pursuit of particular interests in the two countries; between private business people who generate the myriad of cross-border trade and investment transactions; and almost continuously between government leaders and officials to discuss matters of common interest, to negotiate arrangements to deal with bilateral or more general issues, and to resolve bilateral disputes. Underlying the relationship are broad similarities of language, culture and values, similar political and economic systems, and a long history of sharing the North American continent. Nevertheless, there are significant differences in national attitudes and perspectives between Canadians and Americans, reflecting their separate histories and the quite different backgrounds of the populations of the two countries, differences in physical resources and climatic conditions, and other differences in political, social and economic approaches.

It is a common view that one significant difference between Canadians and Americans is in their attitudes toward the role of government. Canadians have traditionally supported greater government intervention in economic and other areas than have Americans. The 1985 U.S.

administration has undertaken to reduce the level of government activity, to deregulate parts of the U.S. economy and to strengthen private enterprise. While a process of deregulation is emerging in Canada, governments at both the federal and provincial levels have sought to achieve stronger economic growth by implementing a range of "industrial strategies" in support of national and regional objectives. This approach has tended to be regarded in the United States as hostile not only to private enterprise but also to U.S. interests.

In some important respects, however, government intervention in economic and trade areas is comparable in the two countries. On the U.S. side, there is a long history of government intervention in support of agriculture, not to mention the defence and aerospace industries. Both governments have also traditionally intervened actively with commercial policies to protect domestic industries against import competition and to enlarge their export markets. Indeed, restrictive and other U.S. trade policies designed to protect or to advance domestic business interests have over the years limited or distorted Canadian economic development, and resulted in recurring bilateral conflicts. At present, domestic pressures in the United States for government intervention on the trade front are unusually strong.

In recent years, strains arising from a complex of domestic and international economic developments have led to growing domestic pressures on both governments for additional defensive or aggressive measures to reduce what is perceived by many as increased levels of "economic vulnerability." Such measures by Canada are, more often than not, directed at the United States, and are commonly in pursuit of nationalistic goals such as, for example, the "Canadianization" of the petroleum industry. Such measures by the United States are often directed at other countries, for example, restrictions on steel imports, but these can have serious "side-swipe" effects on Canada. However, there is a fairly long list of recent initiatives in the United States aimed directly at limiting imports from Canada in a number of important sectors. These have included the threat of countervailing duties on softwood lumber, eastern Canadian fish, hogs and possibly pork, and certain subway cars; the threat of anti-dumping duties on potatoes from eastern Canada; and various restrictive measures on sugar and sugar products.

Each country is the other's largest trading partner; cross-border trade is massive and important to most regions in both countries. Over a representative recent period, the value of trade in goods across the border has been roughly in balance. Thus, in absolute terms, the interest of the two countries in bilateral trade is about equal. Nevertheless the relationship is obviously a highly imbalanced one. Trade between the two countries is of far greater importance to Canada in terms of its proportion of total trade and total GNP. In 1983, slightly more than 70 percent of Canada's merchandise exports and imports were accounted

for by the United States while Canada accounted for just over 20 percent of U.S. exports and imports. The U.S. rate of economic growth and the overall performance of its large economy, as well as its economic and trade policies, thus can determine to a large extent the well-being of the Canadian economy. In contrast, while the behaviour of the Canadian economy and Canadian government policies can affect particular U.S. firms and industries, they do not have the same overall impact. In the bilateral process of give and take, therefore, Canada is normally the junior partner.

The large difference in the sizes of the two economies as well as the difference in their political and strategic power also affects the global perspectives of the two countries. The United States is almost always at the centre of Canada's international concerns, and many of this country's foreign and also domestic policies are focussed on developments in the United States or are developed in response to changes in U.S. government policies. The United States, on the other hand, with its heavier global interests and responsibilities, tends to be preoccupied with events in the Middle East, Latin America and in other troubled regions of the world. Canadians have long complained about a lack of awareness in the United States of Canadian interests and problems, or about U.S. policies directed mainly at third countries which are pursued with little consideration of their impact on neighbouring Canada. In some cases, Canadians may suspect that the United States adopts policies toward a generally sympathetic neighbour partly for the purpose of establishing precedents for advancing its interests in other countries.

Lack of awareness and expertise on the U.S. side concerning Canada, combined with the special sensitivities of Canadians with regard to their national identity and independence, contributes to the tendency among Canadians to overreact to events across the border that affect, or are perceived to affect, their interests. Relatively minor bilateral issues can be elevated to the level of crises and generate defensive, retaliatory reactions which not only raise hostile counter-reactions in the United States but also may damage Canadian interests as well. On the U.S. side, Washington often tends to overreact to Canadian policies that affect even narrow U.S. interests, which in Canada are viewed as reasonable and necessary to pursue special Canadian goals. To defend domestic interests, the U.S. government can mount vigorous campaigns to bring its neighbour to heel. As the junior partner in the relationship, Canada has sought to even the balance somewhat by fostering arrangements with the United States, on a bilateral basis and especially on a multilateral basis, which involve specific and detailed rules for the conduct of economic and trade policy. Such agreed rules, moreover, also provide a firmer foundation for the resolution of bilateral disputes than a process of negotiation in which the United States can exert its greater leverage.

Bilateral relations are complicated by differences in the political systems of the two countries. Although the two systems share certain fundamental principles and features, differences in the constitutional and federal structures, especially the role of Congress in the United States and the role of the provinces in Canada, can complicate and create difficulties for the bilateral trade and economic relationship. In the United States, Congress has large authority in trade and economic areas. The constitution empowers the Congress not only to "lay and collect Taxes, Duties, Imports and Excises" but also to "regulate commerce with foreign nations," and the Senate must give its consent, by a two-thirds majority, to treaties entered into by the United States. Congress has delegated extensive authority to the administration under successive U.S. trade legislation to negotiate trade agreements bilaterally or within the framework of the General Agreement on Tariffs and Trade (GATT). But particularly in recent years, Congress has exerted increasing influence over the conduct of such negotiations, and legislation which may be required to implement such agreements must have congressional approval.

Obstruction by Congress of international arrangements concluded by the administration can often arise from perceptions that the administration is infringing on the role of Congress under the constitution. Congress and the administration also have different constituencies; members of Congress tend to respond mainly to local and regional interests, while the administration has broader national responsibilities.

The division of authority in the U.S. government can greatly complicate the process of negotiations between the Canadian and U.S. governments in trade and related areas. For example, the process of adopting legislation to implement the Canada-U.S. Automotive Products Agreement in 1965 involved a difficult and uncertain debate in Congress. In the late 1960s, Congress refused to approve changes in U.S. anti-dumping legislation and in its complex system of valuing imports for duty purposes, to which Canada attached importance, although the administration had agreed to these changes during the Kennedy Round of GATT negotiations. More recently, the Canadian government and the U.S. administration negotiated and signed a treaty dealing with commercial fishing on the east coast; when the U.S. Senate rejected this treaty, Canadians regarded this as another example of the problem of negotiating with the U.S. government because of the division of authority between the administration and Congress, and the influence that particular sectional or regional interests exert in Congress.

On the Canadian side, international commitments approved by cabinet or by the responsible federal ministers are almost certain to come into force. However, the federal government may require the agreement of the provinces in order to implement international commitments in a number of trade and economic areas. Although under the Canadian

constitution the federal government has sole authority for international trade and foreign relations, the provinces have certain economic and regulatory responsibilities that overlap this federal jurisdiction and stand in the way of the federal government's competence to conclude international agreements in certain economic and trade areas. For example, the main controls on the very large volume of imports of alcoholic beverages into Canada, and their marketing, are exercised not by the federal government but by the individual provinces. In some cases, formal federal-provincial agreements have been negotiated prior to the signing of an international agreement, as was the case, for example, between the governments of Canada and British Columbia with respect to the Columbia River treaty and between the governments of Canada and Ontario prior to the conclusion of the Great Lakes Water Quality Agreement. Recently, the provinces have been demanding a larger role in the development and operation of international trade policies. In response to their requests, more formal arrangements have been made over the past several years for periodic federal-provincial consultations on trade policy issues. Such arrangements, in themselves, however, would not deal with the question of federal competence to conclude international agreements in areas of provincial jurisdiction.

Relations between Canada and the United States in economic and trade areas are never free of friction, and the degree of friction varies as issues are added to, and removed from, the changing bilateral agenda. However, there are large reservoirs of good will, understanding and toleration on both sides, and the bilateral relationship is sufficiently sturdy and resiliant to cope with a good deal of strain over individual issues, even when these bunch up at one time or another. Nevertheless, there have been marked ebbs and flows of overall bilateral harmony, which can affect the resolution of individual bilateral problems. At the beginning of the 1970s and again in 1980-81, a combination of developments resulted in a souring of the general relationship. Subsequently, the climate of the relationship improved markedly. Prime Minister Brian Mulroney has placed great emphasis on the intention of his government to maintain closer and more harmonious relations with the United States. To quote from the November 5, 1984, Speech from the Throne:

My government has taken the initiative to restore a spirit of goodwill and true partnership between Canada and the United States. My government is pleased by the positive response it has received in both the government and private sectors of the United States.¹

This improvement in the general climate of the bilateral relationship has doubtless contributed to the remarkable growth of interest, particularly in Canada, in the possibilities for achieving some form of free trade arrangement between the two countries, reinforcing the trend in Canada toward

recognizing the purely economic justification for bilateral trade liberalization. The government study *Canadian Trade Policy in the 1980s* issued August 1983 by the Department of External Affairs stated that the GATT and other elements of the multilateral trade and payments system have served Canada well, providing an effective means for Canada further to improve access to world markets, to promote economic stability and predictability based on the rule of law, and to manage trade relations with larger countries.² It further stated that the evidence at the time to proceed with a free trade arrangement with the United States was not convincing, and that proposals for such an arrangement did not command broad support. The study instead proposed exploring possibilities for achieving free trade on "a limited, sectoral basis." In succeeding months, however, public support mounted in Canada for achieving broader bilateral free trade arrangements, including support by the Business Council on National Issues, The Canadian Manufacturers' Association and by the chairman of the Royal Commission on the Economic Union and Development Prospects for Canada. On November 5, 1984, the minister of finance, Michael Wilson, in a statement presented to Parliament titled *A New Direction for Canada* said that the new government intended to examine a range of options for bilateral trade liberalization beyond possibilities for achieving this on a sectoral basis as well as opportunities provided by multilateral trade negotiations.³

Approaches to Managing the Relationship

Canadians in the public and private sectors who are involved in the management of Canada-U.S. relations in economic and trade areas confront an almost impossible task of grappling with the myriad of elements involved on both sides of the border. To manage the system effectively, Canadians need a full and continuing understanding of the almost infinite range of developments in the U.S. economy that affect Canadian interests and an appreciation of how these developments can generate pressures within the United States for intervention by federal and state governments with a further impact on Canada. Also essential is a thorough understanding of the exceedingly complex process of government in the United States, at federal and state levels, as well as of the operations of the regulatory agencies and of the functioning of the U.S. legal system. The day-to-day evolution of U.S. laws and policies which affect or can affect Canadian interests requires continuing and careful attention. Canadians also need an appreciation of the role and influence of the large and continually shifting community of public and private sector leaders in the United States whose attitudes and positions will determine the outcome of particular initiatives.

In broad terms, the main thrust of Canadian efforts over past decades to manage the bilateral relationship in economic and trade areas might be categorized along the following lines.

- A search for improved or free access to the large American market for Canadian exports. A process of negotiating mutual reductions of tariffs and other barriers to cross-border trade has continued for almost 40 years largely within the framework of the GATT. As noted above, possibilities are now being explored for further liberalizing of cross-border trade on a bilateral basis.
- Interventions to influence the formulation and operation of the U.S. government's economic and trade policies. These are of various kinds and are undertaken at various levels to head off or minimize adverse effects on Canadian interests and to gain benefits for the Canadian economy. The intervention process involves continuing initiatives by the federal government, provincial governments and the private sector. These initiatives have been extended in recent years to include direct approaches to members of Congress.
- Efforts to obtain exemptions or more favourable treatment under U.S. legislation or policies of general application. Earlier successes in these efforts, such as Canada's exemption under the Interest Equalization Act in the early 1960s, have been regarded as evidence of a "special" relationship enjoyed by Canada at the time, while failure to obtain a similar exemption from the so-called "Nixon measures" in the early 1970s is often viewed as marking the end of such a special relationship. Whatever the accuracy of this interpretation of past relationships, efforts of this kind continue, and most recently have been made to avoid restrictive import quotas and higher tariffs imposed by the U.S. government on certain steel products.
- Interventions to counter the extraterritorial application of U.S. domestic laws and policies. These have been made in areas such as antitrust, controls on "strategic" exports and access to information from banks. In March 1984, a bilateral understanding was reached governing the application of domestic antitrust laws and policies, which extends and supersedes earlier bilateral understandings of this kind.
- Efforts to maintain independent Canadian regulatory policies. The focus of such efforts has been to resist pressures by the United States to harmonize Canadian regulatory systems with U.S. systems, while at the same time avoiding extreme divergencies which would be detrimental to both countries. Recent examples have involved disputes over the regulation of cross-border trucking, problems relating to the natural gas industries in both countries, and airline fares.
- Efforts to protect particular Canadian interests. These have included efforts to avert retaliatory measures by the U.S. government in response to measures introduced by Canadian federal or provincial governments to deal with special or unique Canadian problems, such as subsidies for regional development, the Canadianization of the petroleum industry or controls on foreign investment.

- Initiatives to resolve bilateral disputes through third-party arbitration or conciliation. Over recent years, both Canada and the United States have invoked GATT dispute resolution facilities to help settle a number of bilateral trade issues involving GATT rules, which the two countries were unable to settle through negotiations. The two countries requested the International Court of Justice to rule on the location of the boundary in the Georges Bank area off the Atlantic coast. As discussed in the third section of this paper, there is an evident need to supplement these international facilities for dispute resolution with the creation of bilateral arrangements to deal with economic and trade issues.

However the main thrusts of Canadian efforts to manage the bilateral relationship in economic and trade areas may be categorized, experience over recent decades suggests that there are a number of underlying principles that bear on the effectiveness of these efforts. Canadians should have a full appreciation of the pervasiveness and strength of the impact on Canada of U.S. economic developments and U.S. government policies, and the consequent constraints on Canadian policy making. Canadian policies which affect the United States should be adopted with an understanding of their likely impact on the United States and the probable U.S. responses. Canadian authorities should be well prepared and equipped to assert and defend Canadian interests, as the need arises, and to stand up to whatever reaction may be generated in Washington by demonstrations of Canadian autonomy. Canada should be cautious about linking unrelated issues in efforts to deal with particular bilateral issues. Generally, the larger partner will be in a better position to deploy extraneous issues to its advantage in bilateral negotiations. In fact, both countries have tended to avoid linking unrelated issues in managing the economic and trade relationship. Finally, continuing efforts are required by the Canadian government, provincial governments and the private sector to create an awareness in the United States not only of special Canadian goals and needs, but also, and perhaps more important, of the large U.S. stake in bilateral relations in economic and trade areas and in the well-being of the economy of its largest trading partner.

Multilateral Elements

An effective management system for the bilateral relationship includes the institutions, rules and procedures which govern their economic and trade policies. To a remarkable extent, these instruments of management have been developed during the postwar years within multilateral arrangements such as the GATT, the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD)

and other international institutions. The GATT constitutes, in effect, the main Canada-U.S. trade agreement. It embodies the rules and principles governing bilateral trade and trade relations, as well as facilities for consultations, for the exchange of information about trade policies, and for the resolution of bilateral disputes. The IMF, the OECD, the International Bank for Reconstruction and Development (World Bank), the annual summit meetings, and the regular quadrilateral meetings of trade ministers perform a number of parallel functions in economic areas which form part of the process of managing Canada-U.S. bilateral relations. Both countries have played large roles in the creation and operation of these institutions, and they have a large interest in maintaining and strengthening the multilateral systems which have served them both well. For Canada, these multilateral systems are especially important in the management of bilateral relations because they serve to even up, to some degree, the imbalance between the two countries. In multilateral bodies, Canada can often increase its leverage with respect to particular bilateral issues by aligning itself with other countries having like interests.

Similarly, the main agreements governing economic and trade relations between Canada and the United States are multilateral, rather than bilateral. In 1948, the GATT superseded the 1938 bilateral trade agreement. In financial and monetary areas, the articles of agreement of the IMF and the World Bank embody undertakings of various kinds of both countries with respect to each other, as well as to other members. There are, however, two important and purely bilateral arrangements covering special areas of trade, the 1965 Canada-U.S. Automotive Products Agreement and the Defence Production and Development Sharing arrangements which have their origins in the collaboration which was established during World War II for the production of military equipment and supplies. Both represent special arrangements for limited free cross-border trade.

Bilateral Intergovernmental Structures

Bilateral relationships in trade and economic areas are multi-tiered and multi-dimensional. At the federal level, there is easy and open access to decision-making centres in the two capitals. The Department of External Affairs and the State Department, together with the embassies and consulates of the two countries are the principal and the official channels for intergovernmental business. In recent years, both departments have acquired new strength for the management of the bilateral relationship. The reorganization of the External Affairs department in 1982 subsumed the trade and trade policy components of former Department of Industry, Trade and Commerce. The reorganization gave External Affairs a stronger role within the government for the coordination of trade and

economic relations, and led to the creation of a new position of assistant deputy minister with overall responsibility for Canada-U.S. relations. Six separate divisions beneath it are mainly concerned with bilateral economic and trade relations. In the State Department in Washington, a new position of deputy assistant secretary for Canada was created in 1983 within a renamed bureau of European and Canadian affairs, reflecting a renewed interest and higher priority in the department for relations with Canada.

The External Affairs department, the State Department and the embassies, however, are by no means the only channels for government business between the two capitals. Officials at almost all levels of responsibility in Ottawa and Washington have long been accustomed to conducting day-to-day business directly, by telephone, with visits to each other's capitals, and at international meetings.

The relationship is marked by the near absence of formal structures. The joint ministerial committee on trade and economic affairs, established in 1953 for regular high-level meetings, has not been convened since 1970. Canadian ministers have frequent opportunities to meet with their U.S. counterparts, in either country and at international gatherings. For several years, the secretary of state for external affairs has regularly held discussions four times annually with the U.S. secretary of state. Less frequently, the prime minister and the president have exchanged visits, but, in September 1984, it was announced that Prime Minister Mulroney will meet annually with President Reagan in the future.

An important additional dimension of the bilateral relationship is provided by the extensive network of contacts and arrangements between provincial governments and the governments of U.S. states, especially the border states. As well, Canadian provincial representatives make fairly frequent presentations of their interests in Washington to administration officials and to members of Congress. These interests may not always coincide with the interests of other provinces or of the Canadian government, increasing the complexity of managing the bilateral relationship and sometimes adding to the difficulty of presenting unified Canadian positions in Washington.

Conclusion

The interdependence between Canada and the United States in economic and trade areas has grown in recent years, and is perhaps without parallel. Each country has a large and roughly equal stake in the economy of the other, but the relationship is highly unbalanced. Developments in the United States and in U.S. government policies can have profound and widespread effects on Canada; similar developments in

Canada will usually affect only particular regions and business interests in the United States, although the effects can be serious for those concerned.

A major and continuing objective of Canadian foreign policy is thus to influence the formulation and operation of U.S. policies in trade and economic areas. This involves ongoing efforts by the Canadian government, often but not always reinforced by inputs from provincial governments and the private sector. One constant need is to ensure that Canadian interests are recognized in the United States, and that the U.S. stake in the Canadian economy is also appreciated.

The bilateral relationship is never free of friction, but is sufficiently strong and resiliant to withstand considerable strain. There is greater overall harmony in the relationship than existed several years ago, and the governments of both countries have emphasized their determination to develop new and closer cooperation in economic and trade areas. In Canada, a fairly broad consensus has emerged in favour of new initiatives of some kind to liberalize further cross-border trade and minimize uncertainties that can stand in the way of investment and economic growth.

Both countries have large stakes in their economic and trade relationships with other countries, and the United States carries major global responsibilities. Both play key roles in maintaining the postwar multilateral economic and trade institutions, and these play an important role in the overall management of bilateral relations.

There is an intricate network of relationships in economic and trade areas between the federal governments, at the province-state level, and in the private sector. Each side has relatively easy and open access to decision-making processes in the other country, but the relationship is complicated by differences between the two systems of government, by the role of Congress in the formulation and operation of U.S. economic and trade policies, and by the federal-provincial relationship in Canada. Because of the breadth and intricacy of Canada's economic and trade relationship with the United States, the multilateral and federal-provincial elements involved, and the myriad of private sector interests in cross-border economic and trade activities, it is probably neither feasible nor desirable to look for a single, all-inclusive, institutional structure for the management of the relationship.

Taking these considerations into account, several suggestions are made in the following sections for improving existing arrangements. These sections do not attempt to cover all of the many elements which make up the system of managing the bilateral economic and trade relationship, but focus on five areas of particular interest: arrangements for bilateral consultations; the resolution of bilateral disputes; facilities for research and analysis of bilateral issues; facilities for gathering and

disseminating information to Canadian business about developments in the United States; and a framework for further efforts to liberalize cross-border trade.

Bilateral Consultations

Because of the range, intricacy and importance of Canada-U.S. relations in trade and economic areas, it is essential that effective arrangements be in place for continuing bilateral consultations between the two federal governments. These are needed to deal not only with day-to-day developments of interest to either government, but also with long-run policies and priorities, and especially with initiatives that either country may be planning which can significantly affect the interests of the other.

As noted in the previous section, the formal machinery for consultation between the two governments in trade and economic areas consists of a variety of diverse elements.⁴ A noteworthy and perhaps unique feature of the consultative process is the extensive and much-used network of less formal contacts, often close and personal, between officials in departments of the two governments who deal with trade and economic affairs. Thus the complexion of the bilateral consultation is marked by a paucity of structured mechanisms of a joint nature.

Economic and trade issues are regularly included on the agendas of the annual meetings of the Canada-United States inter-parliamentary group. These meetings provide a useful forum for discussions of these issues among Canadian members of Parliament and members of the U.S. Congress. Their discussions are off the record and informal, and are not aimed at reaching agreed conclusions.⁵ In addition, frequent international gatherings of multilateral bodies offer ample opportunities for discussions between Canadian and U.S. representatives at a variety of levels on trade and economic matters, which diminishes to some extent the need for arranging bilateral consultations in each other's capitals.

There is also a growing network of relationships at the province-state level which involve frequent consultations on bilateral economic and trade developments. Canadian provincial representatives, normally assisted by the embassy in Washington, also have informal contacts with U.S. government departments dealing with economic and trade matters, and with members of Congress.

In the following subsections, some of the elements in the process of bilateral consultation are discussed in more detail.

Ministerial-Level Consultations

Ministers and officials from the two countries have many opportunities to meet and consult on a whole range of issues of common concern. The agreement in September 1984 that the prime minister and the president

will meet annually is likely to add a new, positive dimension to the bilateral relationship over coming years.⁶ These meetings will elevate interest at the highest political level in the overall management of Canada-U.S. relations, and provide regular occasions for consultations at this level on bilateral issues. The government of Prime Minister Mulroney, moreover, has given a stronger emphasis to ministerial-level contacts with Washington, and renewed support for parliamentary-congressional activities. Meetings and other contacts between Canadian ministers and U.S. secretaries, including the heads of the central banks, generally occur on a one-to-one basis to deal with specific issues as they arise. Although meetings of this kind are frequent, they have generally not taken place on a regular, ongoing basis, except at periodic multi-lateral sessions, between Canada's secretary of state for external affairs and the U.S. secretary of state.

During the 1950s and 1960s, the high-level structure for bilateral consultation between the two countries was much more formal. The joint ministerial committee on trade and economic affairs held regular discussions to exchange ideas and to clarify each country's basic objectives and priorities. Over time, it became increasingly difficult to assemble so many busy ministers and secretaries at one time. Moreover, on occasion, issues of a routine kind were included on the agenda simply because a meeting was scheduled, thus burdening the meetings with these issues and unnecessarily raising them to the political level. Meanwhile, action on more important issues which arose between meetings tended to be delayed in order to collect an agenda for the next meeting of the committee. The Canadian media tended to play up failures by the committee to deal effectively with issues on the agenda, thereby exacerbating bilateral disputes; this adverse publicity may have been a main reason why meetings of this body were discontinued after 1970. At present, there is no evident support in either capital for reactivating it.

Since 1982, it has become an established custom for the secretary of state for external affairs and the U.S. secretary of state to meet together regularly to discuss bilateral and other issues of major importance, including economic and trade issues. These meetings between the foreign ministers of the two countries are held three or four times a year, with other ministers and officials from the two countries attending as the occasion demands. The meetings generally do not resolve specific disputes, but they have established a positive tone for managing the bilateral relationship in a broad range of areas, and have focussed attention in both countries on Canada-U.S. relations. One of the most useful elements of the meetings is the preparation for them, which obliges officials in both countries to concentrate on specific bilateral issues as well as on broader bilateral relationships. These meetings are widely regarded as a highly effective arrangement for consultation between the two countries.

These meetings have also tended to strengthen the coordinating roles of

External Affairs and the State Department, and to elevate the Canadian relationship in Washington. This is especially important from the Canadian perspective, since the U.S. government process is far more diffuse and complex than the Canadian, and Canada-U.S. issues have not always had a high level of priority within the United States government.

Consultations at the Officials Level

Consultations on current bilateral issues are continuing activities of officials in External Affairs and the State Department and the staffs of the embassies and consulates of the two countries. But a continuing process of consultations also extends into almost every other department and agency; on trade issues, for example, the lead agency in Washington is the Office of the U.S. Trade Representative. This broad, open and familiar network among officials in the two capitals for exchanges of information, notification of changes in policies, and clarification of issues and interests is a special and valuable feature of the Canada-U.S. relationship. Although this open system may complicate considerably the coordinating roles of the departments, the several joint consultative mechanisms involving officials from specialized departments and agencies facilitate periodic consultations on specific bilateral issues such as trucking, energy and communications. The information exchanges they contribute and the joint working groups formed to deal with specific issues requiring technical or continuing attention attract little media attention. They therefore do not arouse the same high level of expectation and pressure for results as do ministerial-level meetings.

On several occasions, somewhat more formal arrangements have been made by the two governments to improve bilateral consultations in specific areas. For example, in February 1984, Canada's minister of international trade and the U.S. trade representative signed an "Understanding on Safeguards." This agreement, which covers any action taken under GATT Article XIX and any similar emergency actions on imports, builds upon rules already established in the GATT, and provides for advance notice and consultations when either country takes emergency relief action affecting imports from the other.⁸ In March 1984, the Canadian minister of consumer and corporate affairs, the U.S. attorney general, and the chairman of the Federal Trade Commission signed a "Memorandum of Understanding" concerning the application of antitrust laws in both countries. This memorandum elaborated earlier arrangements of a similar kind. Among other things, advance warning is to be given, through External Affairs and the State Department, of antitrust investigations likely to involve the national interests of the other country, or requiring information located in the other country. Each side also undertook to give serious consideration to the other's views in pursuing investigations or seeking information.⁹

Bilateral relations appear to be managed well under existing arrangements without high-level formal arrangements. Canadian representatives have little difficulty in gaining access to their U.S. counterparts. Also, bureaucratic and organizational problems in both countries might well stand in the way of the establishment of any highly centralized institutional structure for consultation. Both the State Department and External Affairs would likely encounter resistance in other departments to proposals for imposing closer control in managing the whole range of issues of bilateral concern. Many departments are accustomed to handling important areas of bilateral relations, such as monetary policy and agriculture, on a day-to-day basis through direct contacts with their counterparts in each other's capitals.

Proposals for Change

Despite the many avenues for communication, numerous suggestions have been made here for improving or elaborating bilateral arrangements for consultation over the years. A 1965 study on improving economic relations found the machinery for consultation to be generally satisfactory, observing that "effective consultation depends far less on machinery and procedures than on the will to consult."¹⁰ Nevertheless, the report proposed the establishment of a committee of deputies by the joint ministerial committee on trade and economic affairs to meet frequently on behalf of their principals and to be available at short notice to consider any emergent problem.

In 1974-75, the Canadian Senate committee on foreign affairs concluded that, while the joint ministerial committee on trade and economic affairs as constituted served no useful purpose, the body should be kept in place and be available in the event both sides wished to revive it or call it for any special purpose. Some of its original purposes, the report suggested, could be achieved by holding unstructured, informal, joint meetings at the deputy minister/deputy secretary level "whenever either side considered it would be useful to get together to discuss bilateral issues."¹¹

In 1981, the Canadian-American Committee issued a policy statement entitled *Improving Bilateral Consultation on Economic Issues*. This policy statement recommended that the two governments should launch "an evolutionary process that will better prepare them to meet the growing challenge of managing bilateral economic relations." This process was summarized as follows:

We recommend that each government designate within it a focal point, permanently staffed with qualified persons, to facilitate its management of bilateral economic issues. Capable of being quickly activated, these two centers, often in cooperation, would mobilize other experienced personnel in each country as appropriate to a particular case. . . . As it gains experi-

ence, the consultative process might evolve to encompass broader functions as judged appropriate to its *raison d'être* of helping the two governments reach individual decisions that are better informed and therefore more likely to succeed.”¹²

This concept by the Canadian American committee of establishing “focal points” in each capital to manage Canada–U.S. bilateral issues was endorsed by Brian Mulroney while he was leader of the opposition, in an address given in May 1984:

We need an improved consultative process but do not need to interpose some new institutional mechanism within the already complex bureaucracies of each country in order to achieve this.

I would therefore like to endorse a proposal which envisaged the designation of a focal point — a small tight secretariat — one for each country, which would be permanently staffed with a small group of experts in Canada–U.S. affairs.

Its function would be to analyse the potentially adverse effects of new policies on each country and anticipate such policies and their effects, in advance. . . .

A key element of this concept lies in its flexibility — the ability to involve other interested groups, where appropriate — be it congress, the state or provincial governments, private businessmen or labour representatives.¹³

Conclusion

Institutional arrangements for consultations on bilateral trade and economic issues should be put in place not for their own sake but to respond to current and anticipated needs. They should be designed to accommodate the intricate and extensive range of bilateral interests, as these evolve, encompassing the many and varied private sector interests and the interests of provinces and states. They should take into account the particularly open and easy channels of communication which generally exist between the two governments at all levels, as well as the frequent opportunities for Canadian–U.S. exchanges within multilateral bodies.

From a Canadian perspective, there is a continuing need for early warning of developments within the U.S. administration and Congress, as well as in state governments, which can affect Canadian interests. Open access is required to departments and agencies in Washington, to members of Congress and their staffs, and to state governments at various levels of authority, so as to ensure that Canadian interests are recognized and taken into account in the formulation and operation of government policies. On the Canadian side, arrangements for parallel consultation with provincial governments and private sector interests

require continuing attention, and should be adapted in the light of changing circumstances and issues on the bilateral agenda.

As a general principle, it is in Canada's interest that U.S. policies in economic and trade areas should be formulated and implemented within the context of broader relationships with Canada; to this end, the role of the State Department in the consultative process should not be weakened. At the same time, it should be recognized that substantive consultations, to be effective, will continue to take place with other departments and agencies in Washington, such as the Office of the U.S. Trade Representative, with the State Department participating in the process in only a marginal way.

At a higher level, periodic meetings between the prime minister and the president are an indispensable part of the process of bilateral consultations on trade and economic matters, as are meetings and other contacts between the responsible Canadian ministers and U.S. secretaries. The regular meetings in recent years between the secretary of state for external affairs and the U.S. secretary of state have made a major contribution to the consultative process, and should be continued. There is no apparent need at present to formalize these meetings within a new institutional structure. At the same time, circumstances may arise where it would be in Canada's interest to initiate a meeting of a larger group of Canadian ministers and U.S. secretaries concerned with trade and economic affairs, perhaps within the framework of a revived joint ministerial committee, for a broad review of bilateral issues. Similarly, and in appropriate circumstances, it may be useful to hold joint meetings of groups of deputy ministers and deputy secretaries of those departments in Ottawa and Washington that carry responsibilities for economic and trade matters.

Arrangements for bilateral consultation need to be multi-tiered and multi-dimensional. The interests and responsibilities of a variety of departments and agencies in Ottawa and Washington represent important factors in the consultative process both bilaterally and also within each country with provincial/state authorities and with private sector interests. By the nature of things, "focal points" will emerge within External Affairs and the State Department, and within other responsible departments and agencies, depending on the issue area concerned. There will doubtless be a need, from time to time, to create special "focal" units or task forces in either or both capitals to deal with particular bilateral issues, bringing together expertise from the various departments and agencies concerned. It is also necessary to preserve, and even strengthen, the responsibilities of the two departments for the coordination of bilateral economic and trade relations. But it would be a duplication of effort, and probably impossible, to assemble the expertise spread throughout government in either capital which would be needed

to create effective, separate "focal points" to manage broad areas of the bilateral trade and economic relationship.

Dispute Resolution

Given the breadth and complexity of the Canada-U.S. relationship, it is to be expected that disputes will arise at times. Policies or measures taken by governments in one country may adversely affect the interests of the other, and the two sides may be unable to resolve them through diplomatic exchanges or a process of negotiations. Indeed, at any given time, there are likely to be a sizable number of disputed issues on the bilateral agenda in trade and economic areas, as in other areas. An effective system of management of the relationship must embody arrangements for the resolution of such disputes to avoid recourse to retaliation and counter-retaliation. Because of differences in size and economic strength Canada, as the junior partner, is at a disadvantage in negotiations with its large neighbour. Thus Canada has a special interest in ensuring that effective arrangements are in place for the resolution of disputes with the United States over trade and related issues.

The potential for the emergence of bilateral disputes is reduced to the extent that the two countries have entered into, and observe, obligations to each other with respect to the conduct of their economic and trade policies. It is not unusual, however, for one country or the other to introduce legislation, policies, or other measures which are inconsistent with their obligations under multilateral or bilateral arrangements or in areas not covered by such arrangements, and which the other country will object to. The affected country will then attempt to persuade the other to modify the offending measure, and possibly to pay compensation in some form for damage already incurred. In certain circumstances, the resolution of the dispute may involve entering into an exchange of new or additional obligations, under either multilateral or bilateral arrangements, to avoid future disputes in the area concerned.

Traditionally, both countries have preferred to resolve their disputes in trade and economic areas through a process of bilateral negotiation. Should this process not lead to mutually satisfactory results, there exists no other, more formal bilateral arrangements for conciliation or for the arbitration of disputes. In recent years, several suggestions have been made for the establishment of such a facility, modelled possibly on the International Joint Commission, which serves to facilitate the resolution of bilateral disputes over the use of boundary waters and in environmental areas. There are international rules and procedures under the GATT to assist the resolution of bilateral disputes in areas covered by GATT articles, and both countries have made greater use of these facilities in recent years. Moreover, the process of consultation and confrontation in

the OECD, the IMF and other international bodies also serves as a less direct mechanism for the resolution of bilateral disputes in certain areas.

Dispute Resolution in the GATT

The GATT has well-established rules and procedures for the resolution of disputes between its members in areas covered by the general agreement and by the supplementary codes. The GATT system embodies the concept that trade disputes should if possible be settled by consultation and conciliation, rather than by retaliation and counter-retaliation, which would lead to an unravelling of the trade liberalization already achieved. The general agreement provides special procedures for arranging bilateral consultations within the GATT framework. If these are not successful, there are other procedures which enable the countries concerned to call on the assistance of the Contracting Parties collectively. The GATT panels or working parties can be asked, on behalf of the Contracting Parties, to conduct investigations and make recommendations to the parties to the dispute. These recommendations, when approved by consensus by the GATT member countries collectively, carry considerable weight. With some exceptions, they generally have been implemented by the parties concerned.¹⁴

The list of trade disputes that have been resolved under GATT procedures is long, and includes several troublesome Canada-U.S. bilateral disputes which the two countries were unable to resolve through negotiations. In the mid-1970s, the United States requested a GATT examination of Canada's import regime for eggs. The result was a solution acceptable to both sides. Several years later, Canada requested a GATT ruling on U.S. restrictions against imports of tuna fish products from Canada. As a result of a finding favourable to Canada, this restriction was removed. In 1982, the United States protested that several elements of Canada's *Foreign Investment Review Act* violated GATT rules; a GATT panel determined that some, but not all, of the disputed elements were inconsistent with Canada's obligations under GATT, and the rules governing the Foreign Investment Review Agency were changed accordingly.

Although the GATT dispute resolution facilities, in theory, have wide application, the Contracting Parties have generally been conservative in dealing with disputes which do not directly involve obligations under the GATT or its supplementary codes. GATT rules apply mainly to trade in goods, and GATT rules deal basically with the use of tariffs and a range of non-tariff measures. Disputes over issues such as those related to trade in services, foreign investment and other economic matters, as well as non-tariff measures which are not covered by GATT rules, cannot generally be resolved under GATT procedures. Thus there are many economic

and trade issues between Canada and the United States that fall outside the ambit of the GATT.

Extension of Reciprocal Obligations

The potential for bilateral disputes and the need for special facilities for dealing with them is reduced to the extent that the two countries observe and agree to extend their obligations to each other with respect to the conduct of their economic and trade policies on either a multilateral or a bilateral basis. In the trade area, the process began with the Canada–U.S. trade agreements of the 1930s. After 1947, it continued in the framework of the GATT, whose rules have been progressively extended and elaborated, especially as an outcome of the Tokyo Round of negotiations. The process also continued on a multilateral basis, in one form or another, for example, under IMF rules relating to the management of exchange rates and the OECD “consensus” arrangement governing the financing by governments of exports on concessional terms. This process of exchanging mutual obligations in economic and trade areas has also continued on a bilateral basis, in the series of pacts between the two countries which was described above.

As an element in the management of bilateral disputes, Canada has a special interest in elaborating and strengthening the bilateral as well as the multilateral norms and rules governing economic and trade relations with the United States which constrain the unilateral application of U.S. laws, policies and practices, reduce the potential for conflict, and lessen the need for the negotiation of particular issues with its larger trading partner.

Domestic Trade Laws

The potential for disputes and the need for special facilities to deal with them is also reduced to the extent that each of the two countries adopts and implements its domestic trade and related legislation in accordance with the rules, codes and guidelines to which both have agreed to bilaterally, in the GATT framework, and under other international arrangements. Failure by one side or the other to translate international rules into domestic law or to implement the agreed international rules has given rise to many bilateral disputes over the years.

One important outcome of the adoption of legislation that reflects international agreements is that many issues that emerge initially as bilateral disputes are ultimately settled in accordance with the domestic legislation of each country. Often, this is the result of a process of investigation and decision making by quasi-judicial bodies. Such bodies have included, in the United States, the International Trade Commission and, in Canada, the Tariff Board and the Anti-dumping Tribunal.¹⁵

These bodies can take decisions on issues that are important to the trade interests of one country or the other. Neither government may be in a position, under domestic legislation, to intervene openly in the decision-making process, and the possibility of resolving the issues involved through bilateral negotiation can accordingly be limited.

Where the terms of U.S. domestic legislation are consistent with undertakings agreed to in prior negotiations with Canada, and the domestic processes are relatively transparent, there may be little room for complaint when bilateral issues are, in effect, settled by the exercise of U.S. legislation. But Canada, like other U.S. trading partners, has reason to be concerned that U.S. legislation, though adopted in accordance with undertakings exchanged in the GATT or elsewhere, may be influenced in its operation by the administration or by Congress, or may later be overridden by new legislation adopted by Congress, in ways that adversely affect Canadian interests.

Bilateral Negotiation of Disputes

Over the years, innumerable bilateral disputes in economic and trade areas have been settled, diminished, or averted through the traditional process of negotiation between the two governments. Still, the outcome may be unsatisfactory when the junior partner loses a retaliatory dispute, when the negotiating process is protracted, or when one side or the other is unwilling to compromise. Disputes can become highly politicized, involving overly aggressive positions on either side; this can adversely affect broader bilateral relations. Some issues are essentially not negotiable for various reasons, especially if changes in domestic legislation are required to settle the issue.

Thus, some important issues in trade and economic areas cannot be satisfactorily resolved through negotiation, nor can they be appropriately transferred to the GATT or other international bodies for assistance in their resolution. No special facilities of a bilateral kind exist at present to assist in the resolution of such disputes in trade and economic areas.

Proposals for a Joint Economic and Trade Commission

There have been several proposals in recent years for the creation of such facilities, modelled in some ways on the International Joint Commission (IJC). Established by the 1909 Boundary Waters Agreement, the IJC is composed of six commissioners, three appointed by each government. Their recommendations carry considerable weight, although they are not binding on the two governments except in circumstances specified in the agreement. The IJC has all along performed a judicial and regulatory function with respect to the management of levels and flows of boundary waters. In more recent times, it has played a major role in

averting conflicts and resolving disputes over environmental issues. It performs this role through a process of joint studies and investigations involving fact finding, analysis and recommendations to the two sides under specific references given to the commission by the two governments. The mandates given to the commission under these environmental references are, of course, drawn up within the context of the obligations of the two countries under the Boundary Waters Agreement with respect to the avoidance of transboundary pollution. But under these references, the commission has focussed not so much on the provisions of the agreement as on the resolution and prevention of disputes through a process of fact finding, monitoring and advice.¹⁶

The list of the commission's contributions to the successful resolution of bilateral conflicts and issues in environmental areas is very long. These include helping in drawing up and operating the Canada-U.S. agreement to clean up and control pollution in the Great Lakes, and in resolving disputes over flooding of the Skagit river in British Columbia and the Garrison diversion project in North Dakota.

The success of the IJC has encouraged discussion of whether joint Canada-U.S. bodies with similar functions should be created to help avoid conflict and resolve bilateral disputes over economic and trade issues. In 1980, Donald Macdonald, the former minister of finance, speaking in a private capacity at a conference at the University of Western Ontario, proposed the creation of a "Canada-United States Trade Commission." The proposed commission would be designed to help resolve disputes in Canada-U.S. trade problems, including those arising from the GATT codes adopted as an outcome of the Tokyo Round. Its structure and functions were suggested by Mr. Macdonald in the following terms:

The proposed commission could have three nominees from each of the two countries chosen from among individuals with expertise in the area of the trade practices being dealt with. The commission would not be an arbitral tribunal, but rather it would have the functions of fact finding and of proposing solutions to both sides, but not rendering any judgement between the parties. . . . No government would be bound by the report, although a unanimous finding of fact and proposals for resolution might limit its room for political manoeuvre. It would be a form of conciliation proceeding directed at achieving an agreed settlement between the parties, normally before other procedures had been used.¹⁷

In January 1984, Senator G.J. Mitchell of Maine introduced a bill in the U.S. Senate calling for an amendment to the Trade Act of 1974 "to authorize the President to negotiate an agreement establishing a joint commission to resolve trade and other economic disputes between the United States and Canada." His proposal was in many respects similar to the proposal made earlier by Mr. Macdonald. Under both proposals,

the proposed commission would have an equal number of nominees or commissioners from both countries. One of its main functions would be to conduct fact-finding investigations and analyses of bilateral issues at the request of governments and perhaps also at the request of private citizens. Under both proposals, the commission would be authorized also to make recommendations to both governments for the solution of disputes; although these recommendations would be non-binding, they would have considerable persuasive power. However, under Senator Mitchell's bill, the proposed commission would also be able to arbitrate disputes over issues referred to it by the two governments.¹⁸

The creation of some form of joint commission on trade and economic affairs, as proposed by Mr. Macdonald and Senator Mitchell, could serve a useful function in the resolution of bilateral disputes in those areas, especially disputes that cannot be resolved by diplomacy or referred to the GATT or other international bodies for assistance in their resolution. The existence of such a body, moreover, would have special advantages for the smaller partner. There has been little support to date by the government in Ottawa or by the administration in Washington for proposals of this kind. The prevailing view in both capitals appears to have been that existing arrangements for the resolution of bilateral disputes in economic and trade areas are sufficient, and that the establishment of additional formal institutions for dispute resolution would simply complicate the process.

Nevertheless, there is a likelihood of renewed interest in some form of joint institution to help resolve and avert disputes in areas involving trade and the economy. In a speech on December 10, 1984, to the Economic Club of New York, Prime Minister Mulroney referred favourably to proposals for new arrangements for the resolution of bilateral disputes: "There have been various proposals for new and improved institutional mechanisms for investigation, analysis and resolution of bilateral disputes, possibly modelled on the International Joint Commission. These are worthy of study."

A dispute resolution institution that functions effectively would require some legal underpinning in the form of a treaty or other exchange of obligations in trade and economic areas, such as the Boundary Waters Agreement provides for the International Joint Commission. The question merits more consideration than can be given to it here. As noted earlier, the work of the IJC in environmental areas has proceeded more on the basis of specific mandates drawn up by agreement between the two governments than on the basis of treaty obligations. The commission's functions have been investigatory and advisory in nature, and it does not arbitrate or adjudicate disputes; the recommendations of the commission may or may not be accepted by the two governments. However, it is probably true that a new dispute resolution institution could more easily be created, and operate more effectively, in the

context of some new, more comprehensive and formal arrangements to govern bilateral economic and trade relationships.¹⁹ Meanwhile, less formal and structured arrangements might be made by the two governments for the joint study of certain bilateral issues, as suggested below.

Joint Studies of Unresolved Issues

Even without the creation of new facilities in the form of a joint economic commission for the resolution of bilateral trade and economic issues, the two governments could establish innovative arrangements which could serve a parallel purpose. One approach would be for the two governments to commission qualified research institutes in Canada and the United States jointly to investigate, analyze and report on issues of particular bilateral concern which have evaded resolution through bilateral negotiations, which fall outside the scope of internationally agreed rules, and which thus cannot be transferred to the GATT or other international bodies for assistance in their resolution. No particular suggestions are made here in regard to specific issues to be studied, except to note that such studies would probably be more concerned with the longer term than with immediate issues. The choice of such issues would in itself be a matter for negotiation, as would the terms of reference of joint studies and the choice of research institutes to be involved.

The two governments might also consider an innovative arrangement aimed at avoiding or minimizing disputes over their use of "contingency" import measures, such as anti-dumping and countervailing duties or restrictions for safeguards purposes. Such an arrangement would involve the use of joint panels, drawn possibly from the Canadian Import Tribunal or the Tariff Board and from the U.S. International Trade Commission. These panels would jointly conduct investigations and make recommendations with respect to the determination of injury to domestic producers under legislation governing anti-dumping, countervailing duties and safeguard measures where such measures would affect bilateral trade. Determinations by the joint panel might be advisory in nature, or might even be "binding," and thus become a precondition for one country to impose anti-dumping duties, countervailing duties or safeguards measures on imports from the other.

At the request of the two parties, or perhaps of either party, such joint panels might also investigate and make recommendations with respect to other bilateral trade problems such as government procurement and buy-national policies. Whether the recommendations of such panels in these cases would be "binding" would be a matter of negotiation, depending on the issue and the circumstances. Consideration might also be given as to whether private interests would be able, with or without reference to the governments, to call for investigations by such joint

panels into issues of particular concern to them involving their particular transborder economic or trade interests.

Arrangements of the kind suggested above for the resolution of bilateral economic and trade problems would not involve conflicts with the obligations of either country under the GATT or with other international commitments.²⁰ Such arrangements would not stand in the way of either country having recourse to established GATT procedures for dispute resolution, but rather would serve as complementary means of dealing with bilateral issues which fall outside the ambit of the GATT, or which for other reasons the two countries do not wish to submit to the GATT for resolution. Moreover, experience with arrangements of the kind suggested above, over a period, would provide a basis on which the two governments could give further consideration to more far-reaching proposals for new bilateral arrangements for the resolution of disputes in trade and economic areas.

Research and Analysis

Canadians have long complained about the lack of awareness in the United States about Canadian affairs and about the importance of the Canada-U.S. trade and economic relationship. In Canada, while there is a far greater awareness of events in the United States, there remains an insufficient understanding of the different structure and operation of the U.S. system of government and its legal system, and of the impact of the U.S. economy upon the Canadian. In both countries, policies are frequently implemented without a full understanding of how these policies could affect the other, and policies are often designed to deal with specific issues without taking into account the overall Canada-U.S. relationship.

An improved process for the management of bilateral trade and economic issues would suggest concentrated and continuing efforts on both sides in the research and analysis of particular issues and of broader aspects of the bilateral relationship. In both countries, the federal governments and also many of the provincial and state governments devote considerable resources to monitoring and analyzing transborder trade and economic issues. However, these governmental efforts are often aimed largely at developing briefs and positions for negotiating purposes, may be lacking in objectivity, and are not often made available to the public.²¹

Independent research institutes and universities can make a particularly useful contribution to a better understanding in both countries of bilateral economic and trade issues and to broader aspects of bilateral relations in these areas. Their studies of bilateral issues can contribute an additional element of objectivity and expertise; they can attract the

attention of policy makers and the general public; and they can be of great assistance to members of legislatures and to officials who are responsible for dealing with economic and trade issues on the bilateral agenda.²²

Existing Joint Research and Analysis

At present, in neither country is there much in the way of structured research and analysis focussed on Canada-U.S. trade and economic relations. There is even less in the way of joint research and analysis of these issues, although a number of Canadian research institutes and universities maintain formal and informal contacts with counterparts in the United States. Occasionally, joint research is conducted into relevant areas of mutual interest to both countries. For example, a "North American Political Economy Project" is currently being co-sponsored by the Canadian Institute of International Affairs (CIIA) and the Canadian Studies Program at Columbia University. Conferences on the bilateral relationship are also co-sponsored by groups from both countries, such as the Lester B. Pearson conferences which have been sponsored by the CIIA and the Council on Foreign Relations since 1971. Workshops on Canada-U.S. relations, focussing on economic and trade issues, are jointly organized by the University of Western Ontario and the University of Michigan.²³ For a number of years, workshops and conferences on legal and economic aspects of Canadian-U.S. relations have been organized by the Canada-U.S. Law Institute.²⁴ The Institute for Policy Analysis at the University of Toronto is just now establishing a joint project with a U.S. university involving both Canadian-U.S. and also U.S.-Mexican economic relations. The most continuous and structured of the bilateral research efforts has been that of the Canadian-American Committee, which since 1957 has been jointly sponsored by the C.D. Howe Research Institute in Canada and the National Planning Association in the United States.

The inadequacy of independent research and analysis of Canada-U.S. relations in economic and trade areas reflects the paucity of university programs in both countries focussed on issues in these areas. There are 20 institutions in the United States with formal Canadian studies programs and another 380 institutions report some involvement in Canadian studies.²⁵ However, most of the courses offered are related to history and literature. In Canadian universities, there are only a few well-developed programs of U.S. studies. A Centre for American Studies, recently established at the University of Western Ontario, has as its primary emphasis the promotion of research, from a Canadian perspective, over a broad range of U.S. affairs and bilateral relationships. Although many universities offer courses related to the United States, only four, the University of Alberta, Carleton University, Mount Allison

University, and the University of New Brunswick, offer degrees in American studies, and one, McGill University, offers an undergraduate degree in North American studies.

A Structured Program of Joint Research

The concept of a structured program of joint research and analysis of Canada-U.S. trade and economic relations is not new. At joint conferences held in 1978 in Washington and Ottawa between the Institute for Research on Public Policy and the Brookings Institution, it was proposed that a permanent liaison be established between the two institutes to sponsor joint research and conferences. More recently, at a seminar in Toronto in March 1984 on Canadian business representation in Washington, Roy Cottier of Northern Telecom Limited proposed that an institute for North American economics be established as a joint program between a U.S. and a Canadian university. Mr. Cottier suggested that this institute should study the impact of all aspects of the Canada-U.S. trade relationship, and could act as a consultant to both governments and to the private sector in both countries.²⁶

It would be appropriate and in Canada's interest for the Canadian government to encourage and support the establishment of a joint program of research in the area of Canada-U.S. trade and economic relations. Because of the apparent lack of university programs specifically in this area, it would seem more feasible at this point to establish such a program of joint research between two prominent research institutes in the two countries. The research program might be assisted by both federal governments, the state and provincial governments, and the private sectors of both countries, possibly through endowment funds which would ensure its independence and financial soundness. The program could include trade or economic issues of mutual concern to the two countries, as determined by the two research institutes involved, although studies could be commissioned jointly or separately by governments in both countries or by groups in the private sector. Such independent analysis, based upon a bi-national perspective, would be of considerable benefit to both countries, and would fill a major gap in the understanding and management of bilateral relations.

Information Gathering and Dissemination

Information systems have come to play an increasingly important role in Canada-U.S. trade and economic relations. The closer interdependence of the two economies, a more open style of diplomacy, and the greater diffusion of responsibility in Washington for international trade and economic policy are largely responsible. These systems, whether operated by the Canadian government, provincial governments, or the private sector, can have a variety of goals. These include: improving the

flow of information about developments in the U.S. economy and about related U.S. government policies likely to affect Canadian interests; providing decision makers in Washington and elsewhere in the United States with information about Canadian economic and trade interests, as part of efforts to influence the formulation and operation of U.S. policies; raising the level of awareness among decision makers and the general public across the border of the nature and extent of the U.S. stake in the well-being of their largest economic and trade partner; and promoting trade, investment and tourism.

The Canadian government, like the governments of many other countries, devotes a great deal of continuing effort to influencing the formulation and operation of U.S. economic and trade policies which can affect Canadian interests. Many Canadian provinces have also participated in this process, and these provincial efforts are increasing, both in Washington and in state capitals. Similarly, the Canadian private sector has always played an important role in the process of influencing the formulation and operation of U.S. legislation, policies, and practices which affect their particular interests. Over a recent period, their involvement in this process has increased in various ways.

There is growing concern in Canada, particularly on the part of the Canadian business community, that insufficient effort is being devoted to the representation of Canadian interests in the United States, given the magnitude, the importance, and the complexity of these interests. To the extent that such activities can be measured, other countries such as Japan, West Germany and Britain, with smaller stakes in the U.S. economy, apply greater resources than Canada to general monitoring of developments in the United States, to public relations activities, and to lobbying in pursuit of their interests.

Changes in government processes in Washington, and their growing complexity, increase the need for more active ongoing efforts to pursue and defend Canadian interests there. One such change is the greater fragmentation of power within the U.S. government. Congress has reasserted its constitutional responsibility for foreign commerce; many responsibilities for international trade and economic policy have been transferred from the State Department to other departments; and agencies such as the International Trade Commission have been given new and larger powers under recent trade legislation. There has also been a dispersal of authority within Congress. The demise of the traditional seniority system and the proliferation of committees and subcommittees — many of which claim authority in one or another area of trade and economic policy — have gone a long way to decentralizing a system that was traditionally dominated by a small number of powerful members of Congress. Congressional staff have also grown dramatically in number and expertise. Moreover, with the decline of party discipline, members

of Congress have become more responsive to the narrower interests of their own constituencies.

At the same time, procedural changes in Congress have made the legislative process more open and transparent, facilitating intervention by foreign interests as well as by domestic interest groups. An entire industry has grown up comprising a host of companies and trade associations with offices in Washington, lawyers, trade and public affairs consultants, and numerous "political action committees" that have been organized by special interest groups. The influence exerted by these better organized private interests has added a new dimension to the process of government in the United States.

Finally, there has been an increase in the scope and complexity of U.S. trade legislation. U.S. industries are now taking more advantage of opportunities to use this legislation to their own advantage, as well as to petition Congress for new forms of import protection or other restrictive measures that can damage Canadian interests. Protectionist forces are strong within Congress, although the administration has generally resisted proposals for restrictive legislation. These developments in U.S. legislation have the effect of enlarging the area of bilateral trade issues that are dealt with through domestic quasi-judicial processes and of narrowing the scope for government-to-government negotiations to resolve bilateral disputes arising from them. However, the same process has enlarged the scope for interventions by private Canadian interests, with or without the support of allied U.S. domestic interests.

Efforts by the Canadian government, provincial governments and the private sector to influence the formulation and operation of U.S. economic and trade policies involve one or more of the following elements:

- gathering accurate, up-to-date information about developments within the U.S. government, Congress and regulatory agencies which can affect Canadian interests, and its timely dissemination to governments and the private sector in Canada;
- seeking specialized legal advice in Washington or elsewhere in the United States in circumstances where questions of U.S. law and its interpretations are involved, or where interventions through the U.S. judicial system are considered useful and possible;
- intervening (or "lobbying") with appropriate sections of the U.S. administration, with Congress, or with regulatory agencies to ensure support for the development of particular initiatives of interest to Canada, reinforced by ongoing information programs and other activities;²⁷ and
- undertaking broad public relations programs aimed at decision makers in the U.S. government, state governments, the U.S. media and the general public.

Federal Government Activities

The federal government carries the principal responsibility for developing unified, well-coordinated economic and trade strategies toward the United States. It carries out this responsibility through the Department of External Affairs, the Canadian embassy and consulates in the United States.

The Canadian embassy has always been highly effective in monitoring U.S. developments of importance to Canada and protecting Canadian interests, and is widely regarded as the most effective and influential embassy in Washington. The Canadian government has recently increased the resources available to the embassy for congressional liaison and for the employment of specialized Washington consultants. However, it is a formidable task for any embassy, however well equipped, to monitor every development that might affect Canadian interests, in Congress or elsewhere within the U.S. government. Moreover, the embassy represents the federal government, and may not always focus on developments that could be of special interest to provincial governments or the Canadian private sector. Indeed, the federal government's interests may not always coincide with those of the private sector or the provinces. The primary role of the embassy is to serve as a channel between the Canadian government and the U.S. administration. In carrying out lobbying efforts, it must tread carefully to avoid alienating the administration and particularly the State Department, whose support is generally essential to the satisfactory resolution of bilateral issues.

Traditionally, the Canadian government has cooperated with provincial governments and the private sector to advance or protect common Canadian interests in the United States. The Department of External Affairs in Ottawa has recently enlarged the number of divisions which serve this purpose. There are obvious difficulties, however, in ensuring a comprehensive and continuing flow of information from federal offices to provincial capitals and to Canadian companies about the many developments in Washington and elsewhere in the United States that could affect their interests.

The Provinces

Because of their constitutional responsibilities in various economic areas, provincial governments have a large stake in U.S. policies affecting their interests, and in the formulation of Canadian policies which affect their interests. Five of the ten provinces have established offices in major U.S. cities, but these are largely to promote tourism, trade and economic development. There are numerous linkages between provincial and state governments as well as special arrangements for coopera-

tion in a wide variety of economic and other areas. No province has an office in Washington, although provincial premiers, ministers and officials visit Washington quite often for discussions with administration officials, members of Congress, and their staffs. Several provinces have hired specialists in Washington to monitor developments related to specific areas such as acid rain or energy. Within the federal government, a federal-provincial relations division in the Department of External Affairs has existed since 1967 to provide a contact point for provincial authorities. It can facilitate meetings and other contacts between the provincial governments and U.S. authorities in Washington, and it distributes information to the provinces of interest to them. In addition, a special unit has been created within the embassy in Washington charged with arranging visits for provincial representatives and otherwise assisting them.

The interest and involvement of provincial governments in international trade policy relations has increased in recent years, and is likely to grow in the future. Provincial governments will probably strengthen their own resources for the collection and analysis of information about developments and policies in the United States and other countries that affect their interests, and they will probably become even more active in pursuing their own interests directly with foreign governments, especially the U.S. administration and the Congress. Thus there is a risk of greater disunity and inconsistency in the presentation in Washington of Canadian economic and trade strategies.

The problems of federal-provincial coordination of international economic and trade strategy are not new. They were examined in detail in 1974-75 by the Canadian Senate committee on foreign affairs, which offered useful advice on ways to strengthen federal-provincial cooperation.²⁸ But new and more structured arrangements may be needed in future for this purpose. More effective arrangements may be required, for example, by the embassy and consulates in the United States, as well as by External Affairs and other departments in Ottawa, to serve the needs of provincial governments for continuing information about economic and trade developments in the United States which affect their interests. Further improvements will probably be needed in arrangements for federal-provincial consultation with respect to Canadian economic and trade policies toward the United States both on an issue-by-issue basis and in regard to broader bilateral relationships. In recent years, progress in this direction has been made by holding periodic federal-provincial meetings of trade ministers.

Should preparations go forward for bilateral Canada-U.S. trade liberalization or a new round of GATT negotiations, there will probably be a need to recreate structures for continuing consultations with the provinces and private interests. These could be modelled on the Canadian Trade and Tariffs Committee and the Office of the Canadian Coordinator

for Trade Negotiations as they existed during the Tokyo Round.²⁹ Indeed, in future trade negotiations, either on a bilateral Canada-U.S. basis or on a multilateral basis, provincial governments may well press for closer participation in the process, including participation on negotiating teams.

The government of Prime Minister Mulroney has stated its intention to proceed in this process in close consultation with the provinces, as well as with private sector interests. The provincial governments, for their part, will need to devote even more of their own resources to make a constructive and consistent contribution to Canadian policies in these areas of the bilateral relationship.

The Private Sector

The interests of the Canadian private sector are represented in the United States in a variety of ways. Several large Canadian companies such as Alcan Aluminum Limited, Northern Telecom Limited and the Seagram Company Ltd. maintain their own offices in Washington to represent their particular interests. Other Canadian companies employ the services of Washington law firms and consultants on a retainer basis to monitor developments of specific concern to their companies. Still other firms or industry associations have employed specialized lawyers or consultants to advance or defend their interests in particular circumstances. Subsidiaries in Canada of U.S. firms may rely upon their parent companies to protect their interests. Generally, activities on the part of the private sector do not involve efforts to present the broad "Canadian" interest but are focussed on the interests of the particular firm or industry.

Many Canadian firms also belong to horizontal-type or vertical-type associations which have counterparts in the United States. Through these transborder associations, there is a continuous exchange of information and views about developments of interest to them in the two countries. One such notable association is between the Canadian Chamber of Commerce and the American Chamber of Commerce, which as long ago as 1932 established a committee on Canada-U.S. relations. This committee meets semiannually to exchange views on a broad range of economic and trade matters.³⁰

Private sector cross-border linkages are thus extensive and close. Nevertheless, over the last year or so, there has been growing concern about the adequacy and nature of efforts of the Canadian business community to represent its interests in Washington. The Canadian Manufacturers' Association is known to be considering the establishment of an office in Washington, either on its own or in association with other Canadian business associations, or making special arrangements with an established Washington firm to represent its interests. One Canadian consulting firm, Public Affairs International, opened an office in Wash-

ington several years ago, with a small but specialized staff to provide clients in Canada with information about economic and trade policy developments of special interest to them; its clients include at present a number of Canadian firms and several provincial governments.

These and other developments demonstrate a growing awareness of the need for a greater and more active presence in Washington by the Canadian business community, and are directed in large part toward information gathering and ongoing analysis of legislative and other developments within the U.S. government. However, it is also evident that a consensus has not yet emerged as to the form this increased Canadian private sector presence should take or how these activities should be financed.³¹

There may well be a greater need in the future for the establishment of a more broadly based office in Washington to serve primarily the interests of the Canadian business community, especially smaller Canadian enterprises. Alternatives and choices for the functions and operations of such an office would need careful consideration. The following proposals illustrate its possible role.

- The office would focus its activities on general monitoring, the dissemination of information, and developing public relations programs which would improve U.S. awareness of the importance and benefits of Canada-U.S. economic and trade relations.
- The office would not engage in direct lobbying efforts. Specialized local firms are better equipped to lobby, but a Canadian business office could offer advice in choosing a Washington consulting or law firm.
- The office would not be designated as the exclusive representative in Washington of Canadian private sector interests. The embassy would continue to play its traditional role in support of Canada's private sector, large companies would continue to maintain their own offices or employ Washington consultants and Canadian firms would need to employ specialists in Washington to deal with specific issues. But the office could assist Canadian industry and trade associations in pursuing their own special interests, and help them link up and pursue common interests with their counterparts in the United States.
- The office would be created and financed by a coalition of Canadian industry and trade associations and individual firms. For an initial period, the federal government, and perhaps provincial governments as well, might make a financial contribution and otherwise assist in its establishment.
- The office would possibly be headed by a Canadian familiar with the Canadian private sector. Because of the complexity of the U.S. government process, it should employ Americans with expertise in this area. There should also be assurances of liaison with the Canadian embassy in Washington to exchange information and advice. The

office would have to build up its services and expertise over a period of time, perhaps several years.

The Framework and Process for Bilateral Trade Liberalization

Over the past several years, there has been a lively and growing debate in Canada over international trade policy and especially over possibilities for the further liberalization of Canada-U.S. trade. A broad consensus has emerged in favour of pursuing more aggressively the expansion of markets abroad for Canadian goods and services and limiting to the extent feasible further protection for Canadian producers against international competition. A fairly broad consensus has also emerged in favour of negotiating new and special arrangements of some kind with the United States to liberalize bilateral trade, as well as to limit further the use of non-tariff and other measures which obstruct, or threaten to obstruct, this trade. Indeed, efforts in this direction were launched in late 1983 in the form of bilateral discussions aimed at liberalizing Canada-U.S. trade in certain sectors. At the same time, apprehensions exist, especially in central Canada, about the ability of certain sectors of Canadian industry to compete on an equal basis with unrestricted U.S. imports, and the consequences of free, or freer, bilateral trade especially for branch plants in Canada of U.S. parent companies. Apprehensions also exist in some quarters about the consequences for Canada's identity and sovereignty in the event some form of free trade area or common market were to be established.

The process of liberalizing cross-border trade and establishing rules on measures on the two sides governing this trade has proceeded since World War II largely, but not entirely, within the multilateral GATT framework. This process will no doubt continue within the GATT framework, and there is now some prospect that a further major round of GATT negotiations will open within the next year or so. Both governments have emphasized their support for strengthening the GATT trade system and their intention to participate in further GATT efforts to liberalize trade on a global basis. At the same time, both the Canadian and U.S. governments have expressed their readiness to consider special bilateral arrangements to liberalize cross-border trade on a sectoral or even broader basis.

The Evolution of Canada-U.S. Trade Relations

For a brief period of 12 years in the mid-19th century, a reciprocity treaty was in effect between the British North American colonies and the United States under which tariffs were removed on a range of so-called "natural products," but not on manufactured goods. This arrangement

was abrogated by the United States in 1866, partly because of a resurgence of protectionism in the United States after the Civil War. Over the next 70 years or so, no special trade-agreement relationship existed between Canada and the United States; the two countries applied their highest tariffs to each other's goods where these were dutiable. These tariffs were very high, especially on the U.S. side, during the 1920s and early 1930s.

The process of liberalization of Canada's trade with the United States may be regarded as having begun with the two bilateral trade agreements concluded in 1935 and 1938 following the reversal of U.S. protectionist trade policies under the 1934 Reciprocal Trade Agreements Act. Since World War II, this process has continued largely within the multilateral context of the GATT which for almost 40 years has been Canada's main trade agreement with the United States. Under the GATT, seven successive rounds of multilateral tariff and trade negotiations have been held, during which the two countries bargained down levels of their tariffs on many products traded across the border, and extended the lower rates to other countries in accordance with their respective most-favoured-nation commitments. The agreement has also provided a set of agreed rules which govern the policies and practices of the two countries with respect to tariff and non-tariff measures, including those applied to bilateral trade. An important part of this process of postwar liberalization of cross-border trade was also accomplished on a bilateral basis by arrangements concluded outside the GATT framework designed to remove particular obstacles to trade or to deal with special conditions of the bilateral relationship. These include the 1965 Canada-U.S. Automotive Products Agreement, the Defence Production/Development Sharing Program, and the special understandings regarding the licensing of controlled strategic exports and the use of "safeguard" import measures. The outcome of the bilateral sectoral trade discussions during 1984 had not been announced at the time of writing (January 1985).

The reduction or elimination of tariffs on cross-border trade as a result of GATT negotiations has been impressive. It has been estimated that when the tariff cuts agreed to during the Tokyo Round are implemented (by the end of 1987), around 80 percent of Canada's exports to the United States will enter duty-free, and another 15 percent will be subject to duties of 5 percent or less.³² The comparable estimate of U.S. exports entering Canada duty-free is considerably less, around 65 percent. Nevertheless, tariffs remain on numerous products, impeding or blocking bilateral trade; and the customs systems of both countries contain administrative and other elements which give rise to uncertainties such as procedures for the valuation of imported goods and for their classification for customs purposes. Some, but not all, of these customs problems are being alleviated as an outcome of the Tokyo Round.

The GATT rules, as reinforced and extended over time, and especially

as an outcome of the Tokyo Round, have served to constrain and discipline the use of non-tariff barriers to bilateral trade. Nevertheless non-tariff measures and "contingent protection" measures, or the threat of their use, present serious obstacles to bilateral trade in certain areas. These include a wide range of measures permitted or mandated by legislation at both federal and state/provincial levels. The list includes anti-dumping duties, countervailing duties (especially on the U.S. side), preferential government procurement or "buy-national" policies, differing product standards and standards systems, and various forms of government intervention in the agricultural sector involving restrictions and prohibitions on imports. The list also includes a variety of policies and measures which distort trade flows, such as subsidies in both countries, but especially in Canada, designed to encourage domestic production, to assist regional development, to promote exports, or to attract investment.

Each country also has a complex range of policies and measures which affect or may block flows of trade in the large sector of services. These policies may be in place for a variety of reasons including the limitations of foreign ownership, cultural development, consumer and privacy protection, and the limitation of employment of foreign workers.

A summary view of barriers to cross-border trade was expressed in a recent paper by Simon Reisman:

With a few exceptions it is no longer the tariff that troubles Canada in her trade with the U.S.A. Rather it is a range of non-tariff barriers, emergency measures, and threats of restrictive action that create the most severe problems for Canadian trade. This is less true for U.S. exports to Canada where the tariff remains a significant obstacle but where the other constraints are of lesser importance.³³

One serious consequence for Canada of actual or threatened measures on the U.S. side which restrict or distort bilateral trade could be their effect on investment decisions. In the face of the operation of U.S. anti-dumping and especially countervailing duty systems, government procurement practices, other policies which impede or distort trade patterns, and potential changes in these and other U.S. trade policies of a restrictive nature, Canadian as well as foreign-owned companies may tend to locate new plants across the border in order to avoid risks and uncertainties even when market considerations favour location in Canada.

The Free Trade Debate

The Economic Council of Canada in 1975 and the Standing Senate Committee on Foreign Affairs in 1982 issued much-discussed reports

which called for the creation of some form of Canada-U.S. free trade area. Over recent months, support for new initiatives to liberalize bilateral trade has been given, among others, by the Canadian Manufacturers' Association, by the Business Council on National Issues, and by the chairman of the Royal Commission on the Economic Union and Development Prospects for Canada. A variety of approaches have been advanced. As noted above, the government's study of trade policy issued in August 1983 in effect rejected the comprehensive free trade area approach and suggested instead an exploration of the idea of arrangements designed to liberalize trade in particular sectors. The government of Prime Minister Mulroney, after taking office in September 1984, indicated that it would review a range of options to liberalize Canada-U.S. trade, not limited to the sectoral approach, including the possibility for further trade liberalization within the multilateral GATT framework.³⁴

On the U.S. side, the reaction to the possibility of reaching special arrangements to liberalize Canada-U.S. trade has been generally positive but guarded, yet was pointedly responsive to Canadian proposals. The 1979 *Trade Agreements Act* required the president to report to Congress on the possibility of free trade arrangements with Canada (and Mexico); but the president's subsequent report did not suggest that such an agreement was desirable or imminent, nor how an agreement might be pursued. In the autumn of 1983, the Office of the U.S. Trade Representative gave positive responses to the Canadian proposals for sectoral negotiations; in February 1984 the two sides agreed to examine, separately, possibilities for liberalizing trade in several product areas. U.S. government statements have suggested their support for bilateral trade liberalization on a sectoral basis is linked with, and part of, broader U.S. strategies to launch a further round of comprehensive trade negotiations within the GATT. At the same time, the Office of the U.S. Trade Representative has indicated a readiness to consider negotiations for bilateral trade liberalization on a more comprehensive basis. It has also indicated that discussions of trade liberalization in particular sectors would need to involve consideration of investment issues in these sectors.³⁵

No announcements have been made at the time of writing regarding the results of bilateral discussions of sectoral trade liberalization. It would appear that this approach has tended on both sides to draw opposition rather than support from private sector interests concerned, and to raise difficult questions of trade-offs within particular sectors and among the sectors concerned. Moreover, difficult problems would arise in GATT if the outcome were to be the removal of tariff and other barriers to bilateral trade on a preferential basis, especially if third-country exporters to the two countries, or either of them, considered their interests would be damaged.

U.S. Negotiating Authority

Since the 1930s, it has been the general U.S. practice for the administration to negotiate trade agreements, bilaterally or within the GATT, under authority delegated to it under successive U.S. legislation requiring approval by a simple majority of the two Houses of Congress, rather than by treaties requiring the consent of two-thirds of the Senate. Additional legislation to implement particular provisions of trade agreements may also be required, involving further congressional approval. It would appear that under existing legislation, the administration has at present sufficient authority, without a further legislative mandate from Congress, to negotiate an agreement with Canada to liberalize cross-border trade. Section 102 of the 1979 *Trade Agreements Act* extended until 1987 the authority contained in the 1974 *Trade Act* to negotiate agreements on non-tariff barriers, and section 104 of the 1984 *Trade and Tariff Act* extended this authority to include the reduction or removal of tariffs, subject to agreement by the House Ways and Means Committee and the Senate Finance Committee.³⁶ However, the precise nature and extent of the administration's authority to negotiate a bilateral agreement with Canada to reduce or eliminate tariff and non-tariff barriers is a subject that requires expert legal opinion, as would be the need and process for the adoption of legislation to implement particular provisions of such an agreement.

A Two-Track Approach to Bilateral Trade Liberalization

The above discussion would suggest an approach to bilateral trade liberalization that would proceed along two tracks. One would proceed within the traditional multilateral GATT framework; the other would involve complementary bilateral negotiations aimed at proceeding farther than is possible within the GATT, and possibly to deal with issues that fall outside the GATT framework.

As noted above, there is now a reasonably good prospect that a further major round of GATT negotiations will open within the next year or so. Preparations for this round were laid out in part by the work program adopted by the GATT ministerial meeting of November 1982, and have been elaborated by later decisions, especially those reached at the November 1984 meeting of the GATT Contracting Parties. These negotiations are expected to cover a wide range of tariff and especially non-tariff measures. Among other things, they are expected to extend or modify a number of existing GATT rules such as those covering government procurement, the use of safeguard measures and trade in agricultural products; they are likely to put in place new rules covering trade in certain service sectors, such as banking and insurance, and covering trade in counterfeit goods; they are expected to try to bring within GATT

discipline a variety of measures, such as voluntary export restrictions which have been imposed outside the GATT framework, and to try to bring newly industrialized countries closer to full participation in the GATT system.³⁷

These negotiations will offer Canada and the United States further opportunities to negotiate the reduction or elimination of tariffs on goods entering into cross-border trade, and to strengthen or extend the body of GATT rules which govern non-tariff measures affecting cross-border trade. The process will also, of course, involve the reduction of tariff and non-tariff measures affecting the trade of both countries with other GATT members, and bring new trade rules into effect on a global basis.

These GATT negotiations, and preparations for them, will not preclude parallel bilateral negotiations between Canada and the United States aimed at the reduction or removal of tariffs on goods traded between them beyond levels either side can agree to on a broader multilateral basis. Furthermore, these bilateral negotiations could also achieve a degree of liberalization and discipline over the use of non-tariff and other measures bearing on bilateral trade beyond the limits that can be agreed to multilaterally.

Suggested Procedure

A procedure along the following lines could be followed in pursuing bilateral negotiations with the United States to liberalize cross-border trade which would complement and parallel negotiations within the GATT; the GATT negotiations could also be expected to liberalize cross-border trade with the United States as well as with other countries.

- The two governments could reach agreement in principle that their common objective is to remove remaining barriers to cross-border trade on a comprehensive basis, with a minimum of exceptions, and to develop additional rules to govern this trade, through a process of multilateral negotiations within GATT and through complementary bilateral negotiations.
- A timetable for the completion of the negotiations could be established, taking into account the likely timetable for the next round of GATT negotiations; realistically, a four- or five-year period might be envisaged.
- The multilateral and the complementary bilateral negotiations could be designed to cover the whole range of tariff and non-tariff barriers which do or could obstruct cross-border trade in goods and services, with no sectors (such as agriculture) excluded in advance.
- Arrangements would be needed for continuing consultations during the negotiations with the provinces and private sector interests. The

arrangements followed during the latter stages of the Tokyo Round might serve as a model, except that it might be necessary to provide for some form of closer participation by provincial representatives in the negotiating process. (Presumably the U.S. government would similarly make arrangements for consultations during the negotiations with congressional representatives, private sector interests and perhaps the state governments.)

The bilateral negotiations suggested above might be expected to lead to some form of arrangements between the two countries which would extend and complement, in regard to bilateral trade, the undertakings of the two countries under GATT and under existing bilateral arrangements; the precise nature of these complementary arrangements would be a matter for joint determination as the negotiating process evolved; a free trade area in terms of Article xxiv of the GATT would not necessarily be the outcome, but need not be precluded.

It would be important that both countries make clear that their bilateral negotiations to liberalize cross-border trade and improve the rules governing this trade would proceed within the context of the international obligations of the two countries and in ways that would not weaken the GATT or other multilateral organizations concerned. The negotiations would not necessarily lead to arrangements of a preferential nature, although such arrangements should not be excluded, in which event they would need to be accommodated within the GATT or reconciled with other international obligations of the two countries.

An approach of the kind suggested above would not involve for either side any dramatic departure from traditional trade policies and practices. It would represent a recognition that there exists between Canada and the United States a closer, broader, and more intricate economic and trade relationship than either country has with any other country. Flowing from this relationship are unique economic and trade problems that require bilateral solutions beyond those provided within the multilateral framework — bilateral solutions that have been worked out in the past to deal with special problems of trade in automotive products and defence procurement, as well as, more recently, to deal with safeguard measures affecting bilateral trade. Further, and most important, a combination of bilateral and multilateral approaches, carried forward in parallel, could in the end prove to be the most effective way of moving toward free trade between Canada and the United States without raising unnecessarily difficult and perhaps insurmountable issues of sovereignty and independence.

If bilateral and multilateral negotiations along the above lines can be launched without delay, the process itself would serve to dampen protectionist initiatives, especially in the United States, which threaten impor-

tant Canadian interests in the U.S. market. An ongoing process of negotiations centring on bilateral trade and trade policy issues would focus attention in the United States over coming years on Canadian economic and trade problems, and on the important U.S. stake in the Canadian economy. Also, by opening bilateral negotiations now, the two countries would encourage broader international agreement to open a new round of negotiations within GATT. Finally, it seems essential to launch such negotiations at a period of renewed and positive interest in the bilateral relationship, when the two governments have both been given new and strong electoral mandates, and before attention in the United States becomes diverted to mid-term congressional elections or other issues.

Summary of Conclusions

1. The Canada-U.S. trade and economic relationship has become broader, more intricate, and closer, as the two economies have become increasingly interdependent. The management of the relationship is complicated by the diffusion over recent years of authority in Washington for trade and economic policy, with Congress asserting greater involvement and control, often in response to private sector interests. On the Canadian side, the management of the relationship is complicated by federal-provincial divisions of authority in certain areas; and the provinces have become more involved in the formulation of trade and economic policy, reflecting their responsibilities in resource and other economic areas.
2. Although the bilateral relationship is never free of friction, it is sufficiently strong and resilient to withstand recurring strains. At present a greater harmony is evident in the relationship than existed during the early 1980s, marked among other things by the agreement of Prime Minister Mulroney and President Reagan to meet annually and the continuing quarterly meetings between the secretary of state for external affairs and the U.S. secretary of state.
3. Bilateral relationships in trade and economic areas are multi-tiered and multi-dimensional. There is a complex network of relationships at the federal level, the province-state level, and in the private sector both among organizations and individuals. Multilateral institutions, such as the GATT, play an important role in the management of the relationship, as do the less structured quadrilateral meetings of trade ministers from the United States, the European Community, Japan and Canada, and the annual summit meetings.
4. Bilaterally, institutional arrangements for managing the relationship are remarkably unstructured. At all levels of government, access to the decision-making process in each other's capital is relatively open, easy,

and familiar. This degree of accessibility complicates the coordination of bilateral relations, and the coordinating roles of External Affairs and the State Department should be preserved and strengthened.

5. It would be a duplication of effort, and probably impossible, to assemble the expertise spread throughout government in the two capitals which would be needed to create separate, single "focal points" for bilateral consultations on the broad range of trade and economic issues, or for the broad management of the bilateral relationship in these areas. When required, special task forces or similar units can be formed to deal with particular issues or problems in particular areas.
6. The potential for bilateral disputes is reduced to the extent the two countries extend, and observe, the body of agreed rules governing their trade and economic policies, whether on a multilateral or bilateral basis, and implement domestic legislation in conformity with these rules. The GATT, along with its supplementary codes, provides the main rules governing bilateral trade and represents the main trade agreement between the two countries. But other purely bilateral arrangements have been concluded and accommodated with the GATT rules to deal with special problems in cross-border trade.
7. Both countries have made use of the GATT rules and procedures for dispute resolution to settle a number of trade issues which could not be resolved through the diplomatic process or by bilateral negotiation. There is an evident need for additional facilities for dispute resolution, and further consideration should be given to proposals for some form of joint economic commission made by Donald Macdonald and Senator Mitchell of Maine. The effective operation of such a dispute resolution facility might, however, require the legal underpinning of some form of new bilateral trade and economic arrangement. Meanwhile, consideration should be given to instituting joint investigations and advice by independent bodies in the two countries on bilateral issues in particular areas.
8. Generally, there is a need for more, policy-relevant, independent research and analysis of the Canada-U.S. relationship in economic and trade areas, and of particular issues therein. The two governments should encourage and support an organized program of joint research in those areas to be conducted by qualified independent research institutes in the two countries.
9. Information systems have come to play an increasingly important role in the management of bilateral trade and economic relations. This reflects, in part, greater participation in the policy-making process by members of Congress, provincial and state governments, and private sector interests.
10. Within the Canadian business community, consideration is being

given to the establishment of an information office in Washington to serve the needs of Canadian business for information about developments in U.S. policies. There is an evident need for such an office, and the initiative deserves the encouragement and support of the Canadian government.

11. A broad new interest has emerged recently in Canada in favour of new arrangements to reduce or eliminate tariff and other barriers to bilateral trade. Various approaches have been suggested. Since World War II, a substantial liberalization of bilateral trade has been achieved mainly within the GATT multilateral framework, but also under bilateral arrangements, notably the Canada-U.S. Automotive Products Agreement. New efforts to liberalize cross-border trade and extend the body of rules governing this trade could be pursued within a further round of GATT negotiations, which might open in 1986. Parallel bilateral negotiations could be commenced, in advance, which would be aimed at reducing on a comprehensive basis tariff and other barriers to cross-border trade, beyond the reductions which are likely to be achieved on a multilateral basis in a further GATT round, and also to seek agreement on rules designed to deal with special or unique problems affecting cross-border trade. The objective would not necessarily be to create a formal free-trade area, nor to establish new preferential trade arrangements, although these outcomes would not be precluded.

Notes

This study was completed in January 1985.

1. Canada, House of Commons, *Debates*, Speech from the Throne to open the First Session, Thirty-third Parliament of Canada, November 5, 1984.
2. Canada, Department of External Affairs, *Canadian Trade Policy in the 1980s: A Discussion Paper* (Ottawa: Minister of Supply and Services Canada, 1983).
3. Canada, Department of Finance, *A New Direction for Canada: An Agenda for Economic Renewal*, presented to the House of Commons by the Hon. Michael H. Wilson, Minister of Finance, November 8, 1984.
4. Bilateral arrangements for communication between governments of the two countries are described and assessed in Canada, Standing Senate Committee on Foreign Affairs, *Canada—United States Relations*, vol. 1, *The Institutional Framework for the Relationship* (Ottawa: Information Canada, 1975); Roger Swanson, *Intergovernmental Perspectives on the Canada—U.S. Relationship* (New York: New York University Press, 1978); and William R. Willoughby, *The Joint Organizations of Canada and the United States* (Toronto: University of Toronto Press, 1979).
5. Reports of Canadian delegations to annual meetings of the Canada—U.S. inter-parliamentary group are published in Canada, Senate, *Debates*; the report of the 25th meeting in Puerto Rico on March 8–12, 1984, is in the appendix to Senate, *Debates*, November 22, 1984. For a discussion of the group and its work, see Swanson, *Intergovernmental Perspectives*, pp. 171–73.
6. During the visit of Prime Minister Mulroney to President Reagan in Washington in September 1984, they announced their intention to meet annually in the future, with a return visit to Canada by President Reagan scheduled for March 1985.

7. The Committee membership initially consisted of the secretary of state for external affairs and the ministers of finance, trade and commerce, and either the minister of agriculture or the minister of fisheries from Canada; and from the United States, the secretaries of state, treasury, agriculture and commerce. In 1961, the U.S. secretary of the interior was added, and in 1963, the Canadian minister of industry. Each delegation also included the ambassadors in the two capitals, and occasionally special advisers such as the heads of the central banks.
8. The conclusion of the "United States/Canada Understanding on Safeguards" dated February 17, 1984, was announced by External Affairs in press release no. 24 dated February 17. The text is available from External Affairs (Treaty Registrar).
9. See Government of Canada, "Canada and the United States Sign Anti-Trust Understanding," a news release dated March 9, 1984. The memorandum of understanding was signed, for Canada, by Allan J. MacEachen, deputy prime minister and secretary of state for external affairs and by Judy Erola, minister of consumer and corporate affairs, and, for the United States, by William French-Smith, attorney general of the United States, and James C. Miller, chairman of the Federal Trade Commission. The text is available from External Affairs (Treaty Registrar).
10. A.D.P. Heeney and Livingston T. Merchant, *Canada and the United States: Principles for Partnership* (Washington, D.C.: Government Printing Office, August, 1965, p. 6, reprinted from the Department of State bulletin of August 2, 1965). The authors, a former Canadian ambassador in Washington and a former U.S. ambassador in Ottawa, were appointed by the prime minister and the president in 1964 to study "the practicability and desirability of working out acceptable principles which would make it easier to avoid divergencies in economic and other policies of interest to each other." See also Swanson, *supra*, note 4.
11. Canada, Standing Senate Committee on Foreign Affairs, *Canada–United States Relations*, vol. 1, *The Institutional Framework for the Relationship* (Ottawa: Information Canada, 1975), pp. 21–22 and 26.
12. Canadian-American Committee, *Improving Bilateral Consultation on Economic Issues, A Policy Statement* (Montreal: C.D. Howe Institute, 1981), pp. 5 and 12–13.
13. Notes for an address by Brian Mulroney, Leader of the Opposition, to the American Newspaper Publishers Association, Montreal, May 1, 1984.
14. Articles XXII and XXIII of the GATT contain its main provisions relating to dispute resolution. The supplementary GATT codes concluded as an outcome of the Tokyo Round of negotiations have their own procedures for the resolution of disputes.
15. On the coming into effect on December 1, 1984, of the *Special Import Measures Act*, the Anti-dumping Tribunal became the Canadian Import Tribunal.
16. A detailed account of the origins, structure, functions and work of the International Joint Commission is in Robert Spenser, John Kirton, and Kim Richard Nossal, eds., *The International Joint Commission Seventy Years On* (Don Mills: T.M. Best, 1981).
17. Mr. Macdonald's proposal is in "Enforcing the MTN Codes: A Proposal for a Canada–United States Joint Commission," in *Non-Tariff Barriers After the Tokyo Round*, edited by John Quinn and Philip Slayton (Montreal: Institute for Research on Public Policy, 1982).
18. Senator Mitchell's bill is in S. 2228 dated January 27, 1984; for an explanation of the proposal see the statement by Senator Mitchell in *Congressional Record–Senate*, January 27, 1984, p. S299.
19. The Canadian Bar Association and the American Bar Association in 1979 adopted a report which they sent to the two governments, regarding third party arbitration of bilateral disputes of a legal nature; see American Bar Association and Canadian Bar Association, *Settlement of International Disputes Between Canada and the United States*, September 20, 1979. For a detailed discussion of this report and the issues involved, see Eric B. Wang, "Adjudication of Canada–United States Disputes," in *The Canadian Yearbook of International Law* 19 (Vancouver: University of British Columbia Press, 1981).
20. It should be noted, however, that safeguard import restrictions imposed in accordance with GATT Article XIX are required to be applied on a global basis on imports of the

product concerned from all sources. Exemptions for bilateral Canada-U.S. trade in the product would thus be inconsistent with GATT rules, and would presumably require some form of dispensation or agreement by other GATT members.

21. While most governmental "in-house" analysis is not publicly available, a considerable number of government studies are released. Recent examples of special relevance to Canada-U.S. economic and trade relations include Canada, Department of External Affairs, *Canadian Trade Policy for the 1980s* (Ottawa: Minister of Supply and Services Canada, 1983) and the background study by External Affairs, *A Review of Canadian Trade Policy* (Ottawa: Minister of Supply and Services Canada, 1983); *Barriers to Foreign Investment in the United States*, an internal study prepared in 1982 by the Policy, Research and Communications Branch, Foreign Investment Review Agency, Ottawa (copies available on request); the three reports by the Standing Senate Committee on Foreign Affairs, *Canada-United States Relations*, vol. 1, *The Institutional Framework for the Relationship*, vol. 2, *Canada's Trade Relations with the United States*; and vol. 3, *Canada's Trade Relations with the United States* (Ottawa: Minister of Supply and Services Canada, 1975-82); and various reports of the Tariff Board and the Anti-dumping Tribunal. The U.S. government also publishes a continuing flow of reports and studies that are relevant to Canada-U.S. economic and trade relations, including those prepared for congressional committees and those issued by the International Trade Commission.
22. Among noteworthy recent studies in Canada-U.S. bilateral economic and trade areas are those by Rodney Grey, *Trade Policy in the 1980s: An Agenda for Canada-U.S. Relations* (Montreal: C.D. Howe Institute, 1981) and *United States Trade Policy Legislation: A Canadian View* (Montreal: Institute for Research on Public Policy, 1982); Fred Lazar, *The New Protectionism: Non-Tariff Barriers and Their Effect on Canada* (Ottawa: Canadian Institute for Economic Policy, 1981); and Stephen Clarkson, *Canada and the Reagan Challenge* (Ottawa: Canadian Institute for Economic Policy, 1982).
23. The first such workshop was held in Ann Arbor, Michigan, in April 1982, organized by the University of Michigan's Institute of Public Policy Studies and the Centre for the Study of International Economic Relations of the University of Western Ontario; a second was held in London, Ontario, in December 1983 and dealt with U.S.-Canadian trade and investment frictions; and a third was held in October 1984 in Ann Arbor and was concerned with trade and investment in service industries.
24. The Canada-U.S. Law Institute was created by the University of Western Ontario, and the Case Western Reserve University of Cleveland, Ohio. Since 1976, it has sponsored a series of workshops and conferences on legal and economic aspects of Canada-U.S. relations. In May 1980, the institute organized a conference on non-tariff barriers after the Tokyo Round; its proceedings were published by the Institute for Research on Public Policy, Montreal, 1982.
25. Association for Canadian Studies in the United States, *Canadian Studies in the United States: A Profile* (Washington, D.C.: The Association, 1983), pp. 5-6.
26. Roy T. Cottier, senior vice president, corporate relations, Northern Telecom Limited, "Speak Up or Be Shut Out," an address to a seminar on Canadian business representation in the United States, sponsored by the Canadian Chamber of Commerce and the Canadian Institute of International Affairs, held in Toronto, March 20, 1984.
27. For a detailed analysis of this process, see Charles F. Doran and Joel J. Sokolsky, *Canada and Congress: Lobbying in Washington* (Washington, D.C.: Johns Hopkins University, Center of Canadian Studies, 1983).
28. Canada, Senate Committee on Foreign Affairs, *Canada-United States Relations*, vol. 1, *The Institutional Framework*, pp. 29-40, contains an examination of province-state arrangements, provincial contacts in Washington and provincial inputs into the formulation of Canadian policies toward the United States.
29. An examination of these arrangements during the Tokyo Round is given by Gilbert R. Winham, "Bureaucratic Politics and Canadian Trade Negotiation," *International Journal* 34 (1) (1978-79): pp. 65-89.
30. It has become a practice for the members of the committee to hold discussions before

and after their meetings with officials in their respective governments concerned with bilateral economic and trade issues.

31. See, for example, Roy T. Cottier, "Associations in the Information Age," a speech prepared for a meeting of the Institute of Association Executives, Saskatoon, Saskatchewan, August 12, 1983; Roy Cottier, "Speak Up or Be Shut Out," and R.G.P. Styles, "Organizing a Canadian Business Presence in the United States: The Alternatives," a speech presented to a seminar on Canadian business representation in the United States sponsored by the Canadian Chamber of Commerce and the Canadian Institute of International Affairs, Toronto, Ontario, March 20, 1984.
32. These estimates can be misleading. They include duty-free trade under the special features of the automotive agreement, and they are based on actual trade flows in 1976. Thus, these calculations give no indication of the volume of trade that is blocked by high tariffs and other barriers on either side, but which might flow if these barriers were removed. The results of the Tokyo Round from a Canadian perspective were reviewed in a government of Canada press kit dated July 11, 1979, titled "Multilateral Trade Negotiations 1973-1979." For an account of the results of the Tokyo Round in terms of Canada-U.S. trade, see Canada, Standing Senate Committee on Foreign Affairs, *Canada-United States Relations*, vol. 3, *Canada's Trade Relations with the United States* (Ottawa: Minister of Supply and Services Canada, 1982), Appendix A.
33. Simon Reisman, "Canada-United States Free Trade," paper presented to a conference on U.S.-Canadian Economic Relations at the Brookings Institution, Washington, D.C., April 10, 1984.
34. Economic Council of Canada, *Looking Outward: A New Trade Strategy for Canada* (Ottawa: Information Canada, 1975); Canada, Standing Senate Committee on Foreign Affairs, *Canada-United States Relations*, vol. 3, *Canada's Trade Relations with the United States* (Ottawa: Minister of Supply and Services Canada, 1982); Canada, Department of External Affairs, *Canadian Trade Policy for the 1980s: A Discussion Paper* (Ottawa: Minister of Supply and Services Canada, 1983), pp. 41-45; James Kelleher, minister for international trade, speech to the Trade Conference, Dalhousie University, Centre for International Business Studies, held in Halifax, November 1, 1984.
35. In September 1983, U.S. Trade Representative William Brock made an early response to the Canadian government's review of trade policy in the 1980s in which he said, "I believe that every opportunity to expand and/or liberalize international trade, either multilaterally or bilaterally, should be explored fully. Therefore, there may be considerable merit in the review's reference to potential sectoral trade pacts between the United States and Canada" (U.S. embassy press release 83-58, dated September 13, 1983). In October 1984, in an address to a conference in Montreal on Canada-U.S. business perspectives, Assistant U.S. Trade Representative Harvey Bale discussed proposed Canada-U.S. sectoral negotiations at some length. He said, "Serious obstacles have been evolving to the multilateral liberalization process, which require us to consider bilateral, as well as multilateral approaches. . . . We do not believe that we should wait for a multilateral consensus before we take concrete steps to liberalize trade. . . . Thus we have welcomed the Canadian government's initiative to explore possible bilateral liberalization agreements in selected sectors" (U.S. embassy press release 84-33, dated October 1, 1984).
36. U.S. embassy, "Provisions of New U.S. Trade Act Explained," press release 84-42, dated October 31, 1984.
37. The GATT ministerial meeting in November 1982 laid out a work program designed to provide a basis for a further round of trade negotiations, and a further round of GATT negotiations was endorsed by the summit meeting in Williamsburg, Virginia, in May 1983; see Frank Stone, *Canada, the GATT and the International Trade System* (Montreal: Institute for Research on Public Policy, 1984), pp. 206-209. Press reports of the November 1984 annual meeting of the GATT Contracting Parties suggest the possibility of a new GATT Round opening in 1986; see *Financial Times*, "Hopes Raised for World Trade Talks Next Year," p. 2, London, December 1, 1984. An account of the annual meeting of the GATT Contracting Parties in November 1984 is in *GATT Focus* 32 (November-December 1984) (Geneva: GATT Information Service).



International Technology Exchange: *An Economic Analysis of Legal Proposals*

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Introduction

One of the major determinants of the economic prospects for Canada will be its ability to keep abreast of contemporary technological developments. For a vibrant economy, though, it is necessary that Canada not only be kept abreast of new technologies, but that the implementation of them be facilitated through appropriate domestic and international policies. To that end, this study analyzes some of the more prominent recurring proposals which deal with the international transfer of technology, including both provisions in patent legislation and policies affecting the licensing of know-how (the knowledge of how to use new technology).

In some respects, Canada's position in the area of technology is schizophrenic. Compared with most of the countries of the world, Canada is quite wealthy; hence, from the standpoint of technology, it is viewed by many as belonging in a group with other relatively wealthy nations. Nevertheless, the amount of actual technological development carried out within Canada is low; more than 95 percent of all patents granted in Canada are to individuals or corporations domiciled outside the country. Although it is not unusual for technologically advanced countries to have over half their patents held by foreigners, Canada's very high percentage is similar to that of many developing countries. Consequently, when it comes to international negotiations concerning the transfer of technology, Canada might better be grouped with less wealthy nations. Complicating the situation further is the fact that a large bulk of our foreign trade is with the United States, a major exporter of technology in both patents and know-how licensed abroad.

One potentially useful framework for analyzing the instruments of technology transfer involves their separation into those that are state or government created and those that are privately created. State-created instruments of technology transfer include policies that either encourage or discourage the transfer of technology. Policies that encourage transfers might include subsidies and other enticements, and possibly even bundled arrangements for foreign direct investment with the import of technologies and the opportunities for on-the-job training in high technology jobs which would be provided to the domestic labour force.

Policies that discourage technology transfer include barriers to both export and import of technology. Examples of barriers to the export of technology abound in the defence industries, while barriers to the importation of technology usually take the form of reducing the expected returns to the original owners of technology. Examples of import barriers include compulsory licensing and compulsory working provisions in the domestic patent act; other examples include taxes, subsidies to domestic competitors, and the creation of differential intellectual property rights for foreigners. In addition, legislation such as the *Foreign Investment Review Act* (FIRA) imposes many compliance costs which are, in effect, an indirect tax on foreign equity control. Since such control often is an indispensable condition for the inward transfer of technology, FIRA can operate to reduce the supply of foreign technology in those circumstances for which owning the technology is more efficient in the promotion of technology transfer than licensing it.

Privately created instruments operate chiefly through licensing arrangements between foreign patentees (or licensors) and domestic licensees. The profit-maximizing and competitive survival incentives facing the foreign licensors encourage them to restrict the uses of their technology by each licensee in order to increase their overall profits. Many of these restrictions, particularly those requiring that licensees purchase their supplies from the patentee or those that geographically restrict each licensee's sphere of operation, are referred to as vertical restrictions. Even within one country, these vertical restrictions pose something of a dilemma for policy makers. On the one hand, they appear to impose anti-competitive restrictions on output; on the other hand, the enhanced profits enabled by these restrictions provide an additional incentive for private firms to engage in inventive activity. The sizes of these competing effects are still the subject of much debate (see Palmer, 1986), and when viewed within an international setting, these competing effects become increasingly complex.

Within this broad framework of instrument assessment, there are many different potential policy stances which can be adopted. For the most part, though, these stances are variations of positions taken in two controversial areas of concern. The first is whether a patent held in Canada by a foreigner will be worked here, i.e., use resources such as

labour and capital here. The second is whether some of the current restrictions included in the terms of patent licences substantially reduce Canada's welfare.

The first concern reflects the mercantilist/protectionist notions underlying many of Canada's barriers to international trade. Many people seem to feel that, even if Canada's scarce resources could be used more efficiently in other endeavours, Canada should encourage more local working of technology developed by foreigners. The main line of this argument appears to be that, although the technology could be used to produce goods for Canadians more cheaply in some other country, Canadians should bear higher costs throughout the economy by inducing the developer of the technology to produce the goods in Canada. The reasons for bearing these higher costs are not always completely clear, however. In some cases the reasons are obvious attempts to generate additional demand (and hence income and wealth) for certain vested interest groups in Canada. In other cases the reasons might include a willingness to put up with these higher costs in exchange for an ethereal sense of well-being which comes from having a local technology industry. Still other reasons might be to appropriate the wealth created by inventions developed outside of Canada or to enjoy the development of on-the-job learning by Canadians in certain occupations. Regardless of the reasons, these higher costs are likely, and the decision of whether to bear them is probably more closely related to the political theories of public choice than to mathematical theories of the costs and benefits of moving toward freer trade. The result is that many countries, including Canada, have incorporated use-it-or-lose-it provisions into their patent legislation. Such legislation frequently takes the form of compulsory working or compulsory licensing provisions.

The second major concern about technology transfer policies covers vertical licence restrictions. These restrictions typically limit the scope for economic action by the patent licensee, for example by including exclusive territorial restrictions, the granting back to the patentee of rights to new technology developed by the licensee, tie-in sales, and the extension of licence fee payments beyond the term of the patent itself. Each of these types of restriction provides a vehicle for increasing the patentee's profits. Although such restrictions are viewed with disfavour when the patentee is Canadian, they arouse even stronger negative feelings when the patentee is non-Canadian. Too often, though, attacks on such restrictions make the fatally flawed assumption that if the restrictions were not allowed the licence royalty fees would not change. Once it is recognized that the royalty fees charged would increase if such restrictions were prohibited, it becomes less clear that the restrictions significantly reduce Canadian welfare. And beyond this recognition, the reality of tit-for-tat in recent U.S.-Canadian policies makes one even less certain about the benefits to Canada of banning such restrictions.

This study is presented in two parts. The first discusses provisions for working patents in Canada, and the second discusses restrictive licensing. Each part reviews some of the leading arguments concerning the policies and analyzes them from the framework of economic analysis. Following these two parts is a concluding, evaluative section.

Local Working Provisions: Use It or Lose It

Legislative provisions relating to the non-working of patents are contained in the *Patent Act*, R.S.C. 1970, c. P-4, sections 67 to 69. The key concept in these sections for dealing with non-working is the idea of abuse of the patent right. Among other things, it is an abuse

1. to fail to work the patented invention in Canada on a commercial scale without satisfactory reason (s.67(2)(a)); or
2. to prevent or hinder the working of the invention on a commercial scale by importing the patented article (s.67(2)(b)); or
3. not to meet demand for the patented article to an adequate extent and on reasonable terms (s.67(2)(c)).

In interpreting what constitutes an abuse, s.67(3) states that “patents for new inventions are granted not only to encourage invention, but to secure that new inventions shall so far as possible be worked on a commercial scale in Canada without undue delay.”

When it is believed that a patent is being abused, the usual remedy is to seek compulsory working or compulsory licensing of it. In Canada, an application may be made by the attorney general or any person interested (generally would-be licensees) alleging that an abuse exists. The commissioner of patents may then grant a licence to the applicant where an abuse has been demonstrated (s.68(a)). If, however, the commissioner is satisfied that the object set out in s.67(3), above, cannot be satisfied by a licence, he may revoke the patent (s.68(d)).

There are also provisions for the compulsory licensing of pharmaceuticals in the *Patent Act*. These are generally analyzed and justified based on public health considerations, rather than non-working; however, many of the underlying economic arguments for these provisions are closely akin to those for other compulsory working and compulsory licensing provisions. In particular, Canadian pharmaceutical manufacturers are permitted to pay only nominal royalty fees to receive compulsory licences for all pharmaceutical patents. This policy, as will be discussed later, probably makes Canadians better off — not because it creates employment in the manufacturing of pharmaceuticals but because it leads to dramatically reduced prices of prescription drugs.

Similar compulsory working legislation exists in Britain. While the phraseology differs slightly, the same grounds of non-working, not meet-

ing demand, and meeting demand by import are present (*Patent Act*, 1977, s.48(3)(a) and (b)). The general purpose is also set out as encouraging the working of inventions, but this is limited to those inventions which are capable of being worked in Britain.

As will be noted below, international agreement has led most industrialized countries to prescribe compulsory licensing as the first solution for non-working. This is the case in Spain, Belgium, Switzerland, Ireland, the Netherlands, Luxembourg, France and Japan. The legislation in the Netherlands provides that working in another country may constitute working for the purposes of this legislation, where such other country reciprocates.

Working in another member country of the European Economic Community (EEC) would be satisfactory for each country's working requirements under the proposed Community Patent Convention, Article 47. Such provisions are often supported in the context of an economic policy that emphasizes regional rather than national interests (see Boehm, 1970).

A number of countries have not confined themselves to abuse as a basis for compulsory licences. In the Netherlands and Germany a licence must be granted by the patentee three years after the patent is obtained, where it is in the country's economic interest. In France, mandatory licences will be granted when the patents are not being worked in a manner that suits the needs of the national economy. It is clear that such phrases as, "in the country's economic interest," or "the needs of the national economy," are quite open-ended and vague. Depending on one's political predilections and/or membership in various interest groups, the phrases could require that the government implement highly restrictive policies, no policies at all, or anything between these extremes.

Significantly, there is no legislation in the United States addressing the non-working of patents held by non-nationals, although such provisions were first proposed there in 1790 (Penrose, 1951, p. 165). In 1972, a bill was introduced in the U.S. Senate which called for compulsory licensing for the non-working of such patents. In the debate that ensued, it was argued that compulsory licensing is a phenomenon of technology importing, rather than exporting, countries (Whitaker, 1974, p. 159). Compulsory licences may, however, be issued by U.S. courts to remedy anti-trust violations.¹

The similarities in national legislation are ostensibly a result of the Patent Co-Operation Treaty of the Paris Union Convention of 1883.² For this study, Article 5A of the Paris Convention is of particular importance. This article provides that "importation by the patentee into the country where the patent has been granted . . . shall not entail revocation of the patent. [Nevertheless], each country . . . shall have the right to take [appropriate] legislative measures providing for the granting of

compulsory licences to prevent abuses, . . . for example the failure to work." In summary, the convention provides in Article 5A that revocation of a patent is permissible only when abuses of the patent cannot be prevented by compulsory licences.

The international abuse of patents has always been a concern of patent legislation. The first act, the *British Statute of Monopolies* of 1624 provided for letters patent which did not cause "Hurt of Trade" (s.6). However, by the beginning of the 20th century, the Canadian act made very specific provision for working. Section 38 of the *Patents of Invention Act*, R.S.C. 1906, set as a condition to a patent that

1. if the patentee had not started to use the invention in Canada on a continuous basis, and made it available at a reasonable price within one year, or
2. if, after a year after the grant, the invention was being imported, .

then the patent would be void. In the 1923 *Patents of Invention Act* these conditions were lessened to those similar to the present ones, although revocation was not set out as a necessary second option after licensing.

In 1935, the *Patent Act*'s provisions were amended to the form they have today (c. 32, s.66). These amendments were brought forth to bring Canada in line with the international convention (House of Commons, *Debates*, 1935, p. 3096). The typical debate related to compulsory licensing centred on alleged suppression of inventions (pp. 3098–3131). However, an opposition member remarked at one point that strong measures were necessary because the pace of technological change moved production from small local industries to large, often American, corporations (p. 3115). That 75 percent (at that time) of the patents in Canada were held by foreigners was also commented upon (House of Commons, *Debates*, 1935, p. 3098). There is, in the *Debates*, some hint of the political desirability of requiring that patents be worked in Canada. The prime minister remarked on the passing of the 1935 Act that the compulsory licensing provision was in place to ensure that Canadian workmen will be employed in the manufacture of patented articles under patents granted by Canada (House of Commons, *Debates*, 1935, p. 3266). This argument is a classic version of the protectionist tendencies underlying use-it-or-lose-it patent policies. Despite the fact that these Canadian workmen are most likely better suited to working in other industries, and despite the fact that some patented goods can probably be provided more cheaply by foreigners than Canadians, many people still seem to feel threatened if Canadian workers are not in greatest demand in every industry. The basic economic principles of division of labour and specialization suggest that even if Canadian workers were the most efficient in every industry, we would be better off if we specialized in some products and left others to be produced in other countries.

The leading case on the interpretation of abuse/compulsory licensing

provisions is a British decision, *Hatschek's Patent* (1909), 26 R.P.C. 228. The essence of this decision is that the patentee must deal fairly between domestic and foreign industries. The test set out there is whether the industry established in the country is as large as it would be if the patent did not exist. The test essentially compares what the patentee has done with what normal market forces would have done in the absence of the patent. Of course, this test makes little sense economically. If the patent is to have any value at all, output under the patent will be less than it would be in the absence of the patent, regardless of the nationality of the patentee. Strict imposition of this test would reduce the value of foreign patents to nothing and hence discourage all patenting and all transfer of technology via patent licence, thereby thwarting the original purpose of patent legislation, the encouragement of disclosure and commerce in trade secrets. Even partial use of this test would create incentives that would inhibit technology transfer.

It is not sufficient, under such a test, that foreign manufacture is more profitable than an operation that could be established in Canada. It must be demonstrated that no profit would be made at all by the patentee before he is allowed to keep a non-worked patent. Nor is it a response that working is now uneconomical because of established low-cost foreign industries (cf. *Hatschek*). The economic feasibility must be viewed as at the time of the grant. Although lack of demand is an excuse for not working a patent, there are also cases which state that the patentee must attempt to create a demand (*Boult's Patent* (1909), 26 R.P.C. 383, *Celotex Corp. v. Donnaconna Paper Co. Ltd.* [1939] Ex C. 12, 128) especially where there is demand abroad (*Harman and Son (London) Ltd.'s Application* [1958], R.P.C. 88). It is, of course, logically difficult to contend that working is unfeasible when someone else is applying for a licence to do just that.

A curious fact about this type of legislation is that it is rarely used. As of 1975, there had been 50 applications made in Canada, resulting in the issuance of eleven compulsory licences. In the U.K., ten applications were made, resulting in two licences. In France and Japan the numbers of successful licences were three and eight, respectively (Muabito, p. 428).

The reason that few licences are applied for was addressed at the mid-winter meeting of the Patent and Trademark Institute of Canada in 1970. It was argued in the *Report of Proceedings* (p. 87) that this paucity of applications arose as a response to the threat of compulsory licensing through voluntary working or licensing, or from ignorance of the provisions, as well as through a lack of demand for licences. The former explanation invokes a principle sometimes referred to as "the threat effect," whereby a patentee, knowing that the potential for compulsory licensing always exists, attempts to make a better deal sooner, to the advantage of both parties.

Taylor and Silberston (1973) also addressed this question in their

discussion of the British patent system. They, too, argued that the lack of applications for compulsory licences does not mean that the provisions do not have an effect by their mere existence (p. 16). Further, they found “little unsatisfied demand for licences among major established firms operating in the U.K.” (p. 186). In addition to the coercive effect of the presence of compulsory licensing legislation, they also noted that many patents are relatively useless without the know-how that would accompany them in a non-compulsory licence. Later empirical support for this argument is provided by Killing (1975), who documents the major role that the licensing of know-how plays in the transfer of technology. Although it might seem plausible for a country to respond to this problem by compelling the disclosure of ancillary know-how, such a policy would be extremely difficult and costly to monitor and enforce because of the scope for selective disclosure by the patent holder. In addition, effective enforcement of the policy would have a corresponding impact on royalty fees.

Further, Taylor and Silberston suggest that established firms with patents of their own may be hesitant to resort to seeking compulsory licensing as provided for in the legislation, for fear of retaliation (p. 187). Finally, compulsory licensing may not arise because of protection through economies of scale and marketing. This latter explanation assumes that either (1) the multinational market is so small relative to the economies of large-scale production, or (2) high transportation costs so significantly affect the demand that as a result it would be extremely inefficient for a licensee to attempt to produce for the same market as the patentee.

The United Nations Conference on Trade and Development (UNCTAD) report on *The Role of the Patent System in the Transfer of Technology* (1975c) also notes that compulsory licences are not frequently used. It attributes this infrequency of use to such phenomena as the comparatively long waiting time to obtain a licence via compulsory licensing proceedings, the sometimes complex transactions and high legal costs involved in obtaining a compulsory licence, the difficulties and costs of demonstrating either that the patent is being abused or that it is not being used in the country's best interests, and to voluntary cooperation by patentees facing the threat of costly compulsory licensing proceedings (p. 50–51).

The policy behind compulsory working was examined by a committee of the Board of Trade of Great Britain in 1946. In the second interim report of that committee, which generally debunked the discussion of suppression of patents, several incidents of the use of patents by foreigners to preserve the British market via the refusal to license were said to have been found. The committee consequently recommended that the act's approach be changed from correcting “abuses” to more of a public policy attitude, reflecting more accurately and explicitly the trade-offs

between different social goals. Compulsory licensing, it was argued, should encourage a patentee to "exploit an invention to the full extent which is desirable for the development of British production and trade" (p. 9). As noted earlier, what this phrase means or should mean is open to serious questions.

The Organisation for Economic Co-operation and Development (OECD) report on restrictive business practices reviewed the policies implicit in working and licensing legislation:

The object of the provisions on revocation of patents or compulsory licensing in the case of non-use of the patent is to ensure that foreign inventors holding national patents do not fail to work them in the national territory, thereby impeding the development of national industry or attempt to prevent importation into the national territory of articles similar to the patented article but manufactured abroad by other producers. (1972, p. 10)

It goes on to note that the patent system is an instrument of public policy to spur invention rather than a recognition of some "natural" property right. Consequently, the argument continues, the system should be monitored to make sure the public good is served:

The object of granting a patent is to bring on the market a new product, process or technique. If a patent is obtained on a new invention or improvement which is not developed, the policy behind the patent system is defeated. (pp. 11-12)

The OECD report also observed, without solid evidence of the importance of the effect, that compulsory *licensing* is a better remedy than compulsory *working* because the threat of the latter would likely dissuade foreign inventors from even registering their patents.

The views reported by the OECD sidestep the question of which industries, if any, should be singled out for government support of their growth and development; nor do these views address the comparative costs and benefits of using compulsory licensing as opposed to other policies such as subsidies or tax incentives to support these industries. Furthermore, they beg the question of why a foreign patentee might try to block importation or even how such a situation might arise. Instead these views implicitly argue that a country should have patent laws but should also be free to import products from countries that ignore the intellectual property rights of the patentee when it suits the importing country. Although such a mercantilist approach might increase wealth in the short run, its long-run impact may actually reduce wealth because of retaliatory measures in the same way that increasing trade barriers do. And if retaliation is of little concern in countries that are predominantly technology importers, these countries might be better advised to eliminate their patent systems completely than to implement such half-way measures. An important qualification to these criticisms of the OECD

position has emerged only recently. Sometimes the patentee's home government may create barriers to the export of technology, perhaps preferring (mercantilistically) to appear to create employment at home or for reasons of national defence. In this situation, use-it-or-lose-it provisions take on an additional role of value if they can be employed or used as a threat in international negotiations concerning the barriers to technology exports.

An interesting quotation, which echoes the position set out in the OECD report and epitomizes the underlying logic of the present study, is from a 1959 government of India report: "Patent systems are not created in the interest of the inventor but in the interest of national economy. The rules and regulations of the patent system are not covered by civil or common law, but by political economy" (para. 20).

O'Brien (1974) examines the costs and benefits of compulsory working (p. 3). The alleged benefits are: the value added to the domestic economy from local production, tax revenue, gains from learning by doing, and, if some product is exported, foreign exchange. Quite clearly, O'Brien has a superficial view of how the economy works. Increasing the value added to the domestic economy from local production and the gains in tax revenues both ignore the offsetting declines in value added and lost tax revenues as productive inputs are attracted from other segments of the economy where their values are higher. This apparent obliviousness toward the fundamental nature of opportunity costs fatally flaws most of O'Brien's arguments.

The costs of production come through foreign influence, according to O'Brien. Both production and pricing decisions will be made by the patentees or their licensees. Where the patentees work on their own behalf, they often import, at high transfer prices, causing a foreign exchange outflow. O'Brien refers to several authors who have found substantial overpricing in pharmaceuticals, electrical products and rubber in South America to show that overpricing of transfers does occur. The fallacy in using such information injudiciously is that it does not recognize that there are many different ways that patentees can and do collect payment for the use of their intellectual property. If one of these ways is closed off, they will surely adjust by charging more in other ways. It may well be that O'Brien's arguments flow from a concern with international wealth inequalities, and that he favours local working as a scheme to redistribute wealth. Such schemes are naïve, however, in that they are likely to inhibit technology transfer and may even have undesired effects on the international distribution of wealth. As was discussed earlier, it might be more effective for some of the countries about which O'Brien is concerned simply to eliminate their patent laws and to withdraw from all international patent conventions.

The Economic Council of Canada (ECC) (1971) discussed the working of foreign-owned patents. It noted that Canada's legislation may on

occasion have resulted in production at favourable costs, which would not otherwise have occurred. For example, a patentee may decide not to work a patent because of a mistaken overestimate of the production costs in Canada. However, there are other instances in which costs do not compare favourably and industries are established merely to retain exclusive control of the patent by avoiding restrictive legislation (pp. 60–61).

The Economic Council of Canada indicates that unworked patents may result first, from unfulfilled hopes; and second, from an attempt to prevent importation or the working of the product in Canada. An example of the second occurs when patents cluster around a worked patent as a defence against imitators (pp. 63–64). Where unworked patents are a sign of economically unviable technology, their existence serves as a useful warning to others. Where patents are used as blocks, however, the ECC argued that they should be removed. Although this argument was made in the context of a discussion of foreign patents, the same reasoning would presumably apply to domestic “blocking” patents.

The lead of the Economic Council of Canada is not followed in *Working Paper on Patent Law Revision*, (Canada, Department of Consumer and Corporate Affairs, 1976), which starts from the premise that the patent law should encourage indigenous technological capability and innovation. From this premise, it is reasoned that innovation is more likely when new technology is adopted quickly. Only by being exposed to the state of the art will Canadian inventors be able to be creative. Consequently, working should be encouraged beyond what would normally be the international pattern of production in the absence of the patent (pp. 97–103).

This argument is probably the most sophisticated made to date. In terms of economics, this *Working Paper* argues that the required working of patents would generate spin-off effects or positive externalities which would not be taken into account by private decision makers. Only by requiring more working in Canada can such external effects be gained. As one might expect, though, the description and the size of these beneficial effects and the costs of attaining them do not lend themselves to easy measurement.

The *Working Paper* notes, however, that compulsory licensing as it is currently constituted is ineffective. The blame for this is placed on the fact that compulsory licences do not make a willing licensor, but merely a licensor; know-how is not transferred but often is a vital component of technology transfer.³ The *Working Paper* therefore advocates what is essentially the turn-of-the-century Canadian legislative position: the patentee must work the invention or must license it within a reasonable period (pp. 103–108).

Aside from the problem that this policy proposal does not deal directly with the selective disclosure of know-how, one of the major difficulties

with this position is that it relies on a qualitative cost-benefit analysis, which in itself is suspect. In addition, its discussion of the costs of such a scheme seems to underestimate and even ignore some of the less specific but perhaps quantitatively important costs. Among these are the costs of seeking and acquiring information about the potential for licence acquisition, of monitoring the behaviour of both the patentee and the licensee, and of negotiating licences. Administrative and transactions costs could easily alter the cost-benefit calculations substantially. Furthermore, potential retaliation by the U.S., even in only tangentially related areas, is given unduly short shrift.

The position of working in the international patent system is examined in *The Role of the Patent System in the Transfer of Technology to Developing Countries* (UNCTAD, 1975c). This report repeats many of the concerns in developing countries about the non-use of patents. Nationals of other countries, it is suggested, may develop inventions using their superior research and development resources and then use the principle of equal treatment, whereby foreign patentees must be accorded the same rights as domestic patentees, to preserve the markets in developing countries for exports. The system may, it is alleged, result in inventive activity in only a few nations, which is not a justification, in UNCTAD's view, for non-use in the developing countries (p. 47).

The UNCTAD report notes that the conditions in Article 5A of the Paris Union Convention, which allow for compulsory licensing as a response to "abuse" of the patent right, represent a compromise between the interests of individual inventors and of the various national economies (p. 49). It also notes that a transnational corporation's decision as to where to locate production depends on relative costs and trade-offs between economies of scale and transportation. UNCTAD argues that to expect an approach that caters exclusively to the manufacturers' needs to prevail in all cases is to fail to recognize the existence of the compromise in Article 5A. As much as they may wish to, the patentees cannot act as if national boundaries do not exist (p. 49).

Because infrequent use is made of compulsory licensing, the report suggests as an alternative the use of licences of right — that is, licences obtainable automatically for a set fee or the patentee faces revocation of the patent. The UNCTAD report argues that revocation, by its deterrent effect, would exert additional pressure on the patentee, and would clear the way for production in the country where the necessary know-how can be supplied without the help of the patentee (pp. 51–52). For the importing country the licence of right has the advantage of reducing the costs and delays of seeking a compulsory licence. From the viewpoint of foreign patentees, however, it merely reduces the expected pay-offs to them, making them even less likely to transfer their technology to a country using this scheme.

The Royal Commission on Patents, Copyright and Industrial Designs

(1960) also dealt with the question of working. It argued (p. 81) that the decision of whether production should be in Canada or not should not depend solely on the decision of the patentee. Whether a patent is worked in Canada should depend on the capital and labour allocation issues that would arise in the absence of a patent right. There should be no legislative bias toward working new inventions, but rather investment should find its way to the most productive fields. Consequently, the legislation proposed by the commission eliminates the policy statement in the current patent legislation, to the effect that new inventions should be worked in Canada so far as possible.

Maybee (1970) discusses the effect of the patent system on Canada's economic position. Maybee argues that compulsory licences to ensure the working of inventions is necessary in a small industrial country like Canada (p. 157). He implies that in the trade-off between higher working and fewer foreign applications for patents, it is preferable to have fewer foreign applications. He acknowledges that in some situations it is more economical to manufacture abroad. He suggests, however, that an application for a compulsory licence would not be made in those circumstances. His suggestion may not be completely accurate. For example, suppose a German firm has a Canadian patent which generates considerable profits for the firm. If a Canadian could sell the patented product at the same high price, it could operate profitably. If there were no patent, however, the production might quite conceivably be carried out at lower cost in some other country. The Canadian firm would apply for a compulsory licence even though production elsewhere would be more efficient. The patentee, if it is a profit maximizer, would object to the licence, preferring to grant it to a lower-cost producer who would be willing to pay more for its use.

Probably the best discussion of the effect of patents on international technology transfer is contained in Penrose (1951). Two chapters are devoted to compulsory working and compulsory licensing. Penrose argues that the original policy behind patents was not so much the rewarding of inventors, but rather the developing of new industries, even though the two goals would often lead to similar policies. Although stated policy changed in the 19th century to one of encouraging disclosure of techniques and the training of apprentices (pp. 137-38), it is apparent from the use-it-or-lose-it policies, either proposed or in effect, that this original policy goal is still important. In the late 19th and early 20th centuries, with increasing international trade, patents by foreigners became a concern, resulting in compulsory working provisions. Protectionists favoured compulsory working because it increased the demand for outputs from domestic industry. At the same time, some free traders seemed to see patents as an affront, and consequently saw compulsory working as restoring the amount of working that would otherwise have been done in the absence of the patent.

Penrose notes that compulsory working is a response to the fear felt by some that patents would be used by foreign patentees to preserve the local markets in which the patents are held for their own output. This fear seems ignorant of the incentive that profit-maximizing foreign patentees would have to produce locally if it were cheaper to do so. Penrose further notes that the introduction of compulsory working in some countries was opposed by the United States and Germany, at that time major owners and exporters of technology (p. 141).

Penrose examines compulsory working from several perspectives and concludes that it is not a desirable strategy. From the consumer's perspective, it is clearly better that goods be manufactured where they can be produced most cheaply. Further, patent protection will stimulate invention and will further the production of cheaper products (pp. 143–45). Nor does compulsory working necessarily help domestic industries, according to Penrose. No benefit necessarily accrues to a domestic industry by the establishment of a new industry or firm in a highly competitive market, for then all the rents would be competed away. Only if domestic investors and employees are freed from competition to some extent will they benefit.

Within an industrialized country, there is no clear gain from compulsory working provisions. Where unemployment exists due to workers refusing to move to obtain jobs, working of the patent will help only if the new plant is established in a depressed area. And to the degree that its unemployment follows the aggregate business cycle, the new industry would on average be subject to the problems that affect the expansion and contraction of existing industries. Where no unemployment exists, the establishment of a new industry will bid up the prices of other factors of production, resulting in reduced output in other sectors of the economy and higher prices to consumers. The patentee will produce in the country so long as the increase in costs is less than his loss in revenue from losing the patent. To the extent that compulsory working encourages plants in non-economic environments, they have economic effects similar to those of tariffs. Indeed, Penrose cites William Bennett, who suggests that most countries' compulsory working laws serve the same purpose as U.S. tariffs (p. 147, n.9).

In developing countries, according to Penrose, compulsory working makes more sense. Compulsory working forces the development of skills in the local labour force, but when a domestic firm could work the patent, compulsory licensing would be preferable. Compulsory working does have a useful role, however, when there are no indigenous firms to work the patent, and the patentee fears that other foreign producers may import if the patent is revoked. This argument contemplates the relatively rare circumstance of there being several international producers of a patented item. In these special circumstances, compulsory working may help a country's economy. A necessary condition for this situation

to arise is that the benefits from local working not be internalized by market forces, for otherwise free operation of the market would be most efficient. Just what these social benefits are is unclear, but they may include external benefits from on-the-job technical training which can in turn be used by other employers in the economy. Even these benefits, however, should be internalized unless local employers and employees are extremely risk averse and do not pursue educational or vocational opportunities adequately because of their reluctance to borrow against future expected returns.⁴ The existence of these external effects, however, does not at all imply that either compulsory licensing or compulsory working are the best policies for dealing with them. It would frequently be more effective to grant direct subsidies for employers and/or employees for programs providing on-the-job training.

Penrose then goes on to examine the effect of compulsory working on the existing individual firms. It has been argued by some that foreign patents hurt existing firms by barring them from new technology, but Penrose rejects this position. This effect is not produced uniquely by foreign patents; any patent restricts access to technology. Further, the technological dominance of one country is not qualitatively different from the technological dominance of a region in a country. That the United States has more technology than a lesser developed country is intrinsically no more unfair than that California's Silicon Valley is more technologically advanced in some sense than Kansas. Penrose also argues that compulsory working may result in the establishment of foreign-owned factories in an industry, and may consequently impede the rise of domestic firms.

There is little evidence that more plants are established by compulsory working. Furthermore, Penrose argues, the prime benefits to large-scale importers of technology flow from a lessening of patent restrictions. Although most advocates of compulsory working argue that the principal benefit comes from having more plants in the country, Penrose argues that the real benefit flows from the loosening of the patent laws. Patent protection is a species of property, and where that property is held outside of the country and the fruits of it flow outward, compulsory working appropriates the right to firms within the country. Local manufacturers without their own research and development facilities and local consumers, in fact, often advocate compulsory licensing, not because there is anything particularly offensive about foreign patents, but rather because they dislike the fact that profits are generated by patents in general and find foreign patentees the easiest targets.

With respect to remedies, Penrose points out that revocation is inconsistent with the principle of international protection of patentees and generally reduces the incentive for inventing. Compulsory licensing with compensation for the patentee is consistent with these policies.

In her chapter on compulsory licences, Penrose notes that while such

licences are often justified as an encouragement to work patents locally, their essential function is to lower the general level of patent protection. For this reason, countries with many patents registered abroad, such as the United States, have always opposed compulsory licensing (p. 172). Penrose argues that compulsory licences based on non-working will often be too broad, since there are many circumstances primarily involving factor price differentials where it is not desirable that the patent be worked in the country. At the same time, non-working is only one type of abuse, and so a licensing system based solely on that criterion would be too narrow.

As indicated by Penrose, the Americans are hostile to compulsory working/licensing, probably recognizing that the effect is to lessen patent restrictions and hence to lessen the value of their aggregate patent portfolio. However, their attitude has not yet seemed to be retaliatory. The patent counsel for General Electric, Martin Kalikow (1976), has characterized worldwide agitation toward stronger legislation as "a frenzy of rhetoric and retaliation against imagined abuses." He characterized the phenomenon as a temporary one, but urged that, insofar as profitable production in the foreign country was possible, it should be done. Why he would make such a statement is unclear. If he is truly advocating that firms set aside the profit objective in any amount at all, perhaps his stockholders and senior executives should be concerned. Alternatively, the policy he advocates may be consistent with long-run profit maximizing to the extent that private foreign aid serves a useful public relations role.

In summary, use-it-or-lose-it provisions concerning the local working of foreign patents are often quite protectionist in nature. The provisions of compulsory licensing and the compulsory working sections of patent acts have the effect of threatening the patent holder with a personal wealth reduction through patent revocation or licensing at less than the full monopoly value of the licence, unless some of that monopoly value is foregone through higher-cost local working of the patent. The patent holder then must choose between the two possibilities, selecting the less onerous form of reduction of his monopoly profits.

But in the face of this decision, another alternative presents itself: the inventor can decide not to patent the product at all in that country. Such a choice may leave open the possibility that someone else would patent the invention, but in cases for which the acquisition of supporting technology and know-how are necessary for the working of the patent, such a possibility may be remote. In this case, the country which threatens to impose compulsory working or licensing provisions would be no better off than it would be without the provisions, and it might even be worse off if the provisions actually inhibit technology transfer.

There is a certain ingenuousness in many of the writings which advocate use-it-or-lose-it provisions in that they ignore substitution pos-

sibilities. They seem genuinely unaware of the fact that, if one type of reward is changed, people will have an incentive to change their behaviour. The result is that less technology will be transferred or that other licensing provisions will change to counteract such provisions.

There are only two arguments favouring these provisions which have any merit. The first, in its boldest form, is pure rent-seeking behaviour: patentees are granted the right to earn monopoly rents, and small technology importers can appropriate some of these rents for their citizens by requiring that the royalties charged by the patentees be set at very low levels for local licensees, as is the present situation in Canada for pharmaceuticals. Although such a policy may discourage some technology transfers, its negative effect is likely to be small so long as the technology importing country is small relative to the rest of the world market, and so long as it is confined to industries for which supporting technology and know-how are of little importance.⁵ It has been argued by U.S. pharmaceutical manufacturers and their Canadian subsidiaries that such compulsory licensing provides an incentive for them to relocate their research and development activities outside of Canada. This argument is without merit. Research and development (strategic behaviour aside) will be located wherever they can be carried on most efficiently; and the fruits of these activities will be sold wherever the sales are profitable. There is no intrinsic link between sales and research locations.

The second argument uses the economic concept of externalities as its foundation. According to this argument, having a local industry which uses the latest in technology will generate sufficient know-how that people working in that industry will then be able to develop more new technology locally, and the country will be less dependent on foreigners for its technology in the future. This argument is not as evident as its proponents might think, however. If locally developed technology is sufficiently rewarded, employees with a technological talent should be eager to apprentice themselves to the high-tech foreign patentees so that they can use the on-the-job training they receive to earn higher incomes in the future. In other words, it is not immediately clear why these benefits cannot be (and indeed are not) internalized into the private maximization decisions of the citizens of the technology-importing country or could not be obtained more efficiently with more direct policies such as grants or subsidies.

One possible explanation for this alleged lack of internalization of the benefits hinges on the aversion of individuals to taking risks. The possibility that apprenticed employees will be able to strike it rich later has an extremely variable expected pay-off, and many talented people who wish to avoid risks will forego the opportunity to work for low wages now in exchange for the possibility of earning large incomes in the distant future. If they were willing to work for low wages now, the patentee

would be much more likely to locate more productive activity in the technology-importing country; but the employees' relative aversion to risk induces them to demand higher wages, which in turn raise the costs of producing the patented output locally.

One way to overcome such risk aversion might be through grants and subsidies, but, if the country is small relative to world markets and has little to fear in terms of retaliation, it may be able to force many foreign patentees to share these risks via use-it-or-lose-it provisions. To be sure, such provisions will inhibit the transfer of some technology, but, as indicated previously, this loss may be small and worth bearing.

Restrictive Licensing Provisions

Hindley (1971) sets out the premise that restrictions on licences are implicit in the idea of a patent, and should not automatically be considered abuses. Restriction on output is the basic idea behind the patent system. This idea is developed in greater depth in Palmer and Resendes (1982) and in Palmer (1984).

The law in Canada permits, in general, any sort of restrictive provision in a licence except resale price maintenance (*Hatton v. Copeland-Chatterson Co.* (1906), 37 S.C.R. 651). The restrictions then apply to any downstream party who has notice of them; for example, a product may be licensed for use and sale only in Canada (*Rhone-Poulenc S.A. v. Micro Chemicals Ltd.*, [1965] S.C.R. 284). The general philosophy exemplified by these decisions is that, as the patentee owns the right, he can grant it in whole or in part, as with any other contract.

This breadth is, of course, limited by the provisions of the *Combines Investigation Act*, 1976, R.S., c. 314. Section 29 provides that where the rights confined by a patent are used so as, *inter alia*, to restrain or injure commerce in the invention, the agreement doing so may be declared void in whole or in part. Price maintenance is, of course, illegal under section 38; i.e., fixing a resale price in a patent licence is illegal. There has apparently been no prosecution under these sections for restrictive terms in patent licences.

Interesting legislation, which goes much further than that of Canada, is Mexico's. The *Law for Technology Transfer*, as summarized in Finnegan and Goldscheider (1980, pp. 360.58–360.60), provides in Articles 2 and 3 that all licences for the use of patents must be registered where a party is a Mexican national or resident. These agreements are not registerable, however, *inter alia*, when the provisions permit the supplier to intervene in the transferee's administration of the technology, when there is an obligation to obtain any supplies from a given source, when exportation is prohibited, when the use of complementary technology is prohibited, or when volume of production or sale is limited.

The OECD *Restrictive Business Practices Report* discusses the legal

position on territorial restrictions in several industrialized countries. Restrictions within the territory of the patent law are generally lawful since it is accepted that the patentee may grant an exclusive licence for each territory covered by the patent law. Territorial restrictions beyond the local patent law, such as restrictions on exports, are often caught by restrictive business practices legislation. In the United States, Germany and Japan, the restriction is also effectively unenforceable. Under the law in those jurisdictions the restrictive terms of a licence under a patent do not apply to purchasers of the patented article and subsequent downstream parties.

At the international level is the *UNCTAD International Code of Conduct on Transfer of Technology*. Much of the literature to be examined subsequently has been written in response to this code. A review of the code's terms will be useful for this reason and because it provides a convenient catalogue of potentially objectionable restrictive terms. Although the code does not impose any binding legal obligations vis-à-vis national laws, it would prohibit the following terms:

1. restrictions on field of use;
2. restrictions on the acquisition and use of competing technologies;
3. volume restrictions;
4. package licensing: where a patent is only available in a package with other patents which the licensee may not want;
5. tied purchases: where the licensee is obliged to purchase some or all of his materials from a particular source, usually the licensor;
6. quality control requirements;
7. territorial and distribution restrictions;
8. restrictions as to resale;
9. price maintenance;
10. requirements that the licensee grant back to the licensor any improvement he may have made in the technology;
11. restrictions on research by the licensee;
12. limitations on the employment and training of local personnel;
13. requirements regarding compulsory purchase of inventions or technological improvements.

In addition, the code calls for most-favoured-licensee requirements for developing nations.

The UNCTAD Code is much stronger than its predecessor on the international scene, the *Model Law for Developing Countries on Inventions*, drafted by the United International Bureau for the Protection of Intellectual Property. That document proposed that clauses imposing restrictions "not deriving from rights conferred by the patent" be prohibited (Act 33). Explicitly allowed, however, were clauses that limited the extent of exploitation of the licence and limitations aimed at encouraging the technically flawless exploitation of the patent.

The literature in this area is split into two distinct positions. That written by neoclassical economists in developed countries criticizes the code for the lack of flexibility it will impose on negotiations and the concomitant reduction in technology transfer. Others write from the perspective of the necessity of leaving the developing countries as free as possible to exploit the technology. Because of Canada's position as a major technology importer, it is easy to address most of this second group of arguments directly or by analogy with respect to policy proposals in Canada.

McFetridge, in an address to the Patent and Trademark Institute of Canada, discussed the economics behind several restrictive licensing practices: export restrictions, tie-in arrangements, and grant-back provisions. Clearly these practices help the licensor increase his returns from the technology, thus increasing its value to him. With export restrictions, for instance, countries can be segregated and charged different prices. Patentees, by price discriminating among the customers in different countries, can substantially increase their profits, which in and of itself provides a greater incentive for innovation. In addition, the charging of higher prices to some customers allows patentees to add marginally to their profits by charging prices which barely cover their variable costs to others unable or unwilling to pay higher prices. Since many developing countries fall into this latter category, price discrimination probably benefits them, allowing profitable technology transfer when it would be impossible under a single price regime. Since Canada is both a technology importer and likely to be charged higher prices because of its relatively high standard of living, from its viewpoint international price discrimination in patent licensing is perhaps undesirable. McFetridge also pointed out that export restrictions reduce negotiating costs by limiting the scope of the licence. Similarly, a tie-in clause effectively facilitates profit-maximizing price discrimination by allowing high value and low value users to be separated.

McFetridge and Smith, in an unpublished paper entitled "Property Rights and Technology Transfer," discuss some of the microeconomic implications of licensing practices (pp. 21-24), basing much of their analysis on the concept of bounded rationality. In essence, they report that, when there are many contingencies in a situation, a point will be reached where dealing with these contingencies costs more than the benefit of the contract. One of the classic treatments of this problem of incomplete contracting is provided in Williamson's analysis of the bidding for cable television franchises (1976). In such situations, a technology transfer would arise only where the negotiating parties are within a single hierarchy, such as a corporation.

McFetridge and Smith note that the uncertainty associated with negotiating a licensing agreement may be reduced by limits, such as the geographic market, thus helping to reduce the problem to proportions

which are manageable within the constraints of bounded rationality. Contingencies can also be limited by provisions such as grant-backs. By implication, the elimination of such contingencies and the reduction of uncertainty and the costs of trying to allocate risks will result in a higher rate of technology transfers.

In an article in the *Journal of the Patent Office Society*, Finnegan (1978) discusses the UNCTAD Code's prohibition of restrictive practices. Finnegan's analysis is based on which system will maximize transfers. With respect to tie-ins, Finnegan argues that a prohibition may not be justified, and may reduce transfers where the licensor is interested in the quality of the product.⁶ (For a more complete discussion of patent licences and tie-ins, see Palmer, 1984.) Finnegan agrees with the proposed prohibition of package licensing. He believes that, although some technology may be necessary for the use of other technology, letting the purchaser decide which technology is desired or necessary will not reduce transfers. It is likely, however, that Stigler (1968) would disagree with Finnegan on this point. Bundling patents for licensing may provide an effective means of risk reduction for both the patentee and the licensee if neither knows which patents in the bundle will be most valuable for a particular market.

Finnegan argues, however, that tie-out clauses (banning the purchase of substitute products) should be prohibited since they limit the ability of a less developed country to determine for itself the evolution of indigenous enterprises. Finnegan also opposes price fixing in patent licences and claims that price fixing is illegal under U.S. and EEC law. He is clearly in error with respect to U.S. law.⁷ He also opposes an absolute ban on production volume restraints on the grounds that this provision is a significant "chip" in negotiations.

Field-of-use restrictions are defended on the rationale that without them, the licensor would have to charge more to compensate for his inability to write multiple, use-specific licences. With respect to unilateral grant-backs of technology, Finnegan observes that, if a non-exclusive transfer back to the owner were not available, the original transfer would be discouraged. In this instance, if grant-backs were prohibited, royalty fees would likely be higher and would discourage technology transfer, especially to risk-averse firms. Following this line of argument with the rest of the restrictive provisions, Finnegan bases his arguments on legal principles. Underlying each, however, is the implication that where a mutually beneficial provision is prohibited, the result will be a higher charge for the technology, and consequently fewer transfers.

Wallender and Holland, the authors of an analysis of an UNCTAD draft outline in Holland (1976), defend many of the restrictive terms found in technology licences. They support these conditions based both on arguments of the legitimate self-interest of the company owning the tech-

nology and the objective of increasing technology transfers to developing countries. In their opinion, control by the source firm of some aspects of the production activities is justified by the interest of that firm in not having an inferior product produced. An example of such a condition is a tie-in for the purchase of raw materials. Another is quality control. Even where trademarks are not involved, the overall image of the technology may be harmed if consumers fix the blame for quality problems on the patentee rather than the licensee.

A second reason for the firm to control aspects of decision making is its desire to prevent the use of the technology in competition with products of the source firm. If licensees are going to compete with the patentee, it should be expected that they will be charged higher licence fees. To the extent that restrictive clauses require domestic firms to use specialists from the source company, it is argued that this is in the domestic country's interest, because more technology is imported. As well, these clauses cause domestic income to rise because of fewer breakdowns.

Direct restrictions on exports can have mixed effects on an economy. Although it is apparent that most countries wish to encourage exports, the response of the source firms must also be anticipated in appropriate policy making. The demand for unrestricted rights, if implemented on a wide scale, will create competition among countries and will encourage suppliers to favour the largest markets, ignoring production possibilities in smaller countries. Alternatively, the policy could cause higher prices to be charged for unrestricted rights because countries requiring unrestricted use of patents will be considered less desirable recipients. The flow of technology would be pushed toward subsidiaries or other large foreign firms. Finally, where unrestricted licences result in higher imports into the source country, the potential response of that country's government in terms of restrictions on technology transfers (i.e., barriers to technology exports) must be considered.

Free access to related technologies of the source company is analyzed in the same fashion by Wallender and Holland (1976). A higher price would be charged to compensate for confidential material or for anything else affecting the source company's competitive capacity (p. 81). A higher price would also be charged if grant-backs of technological improvements were prohibited. If licencees retained the rights to their improvements, then the source company would have to charge a higher licence fee in the anticipation of possibly having to pay more in the future for the potential improvements in the technology. The authors suggest, however, that some compensation should be made for the grant-back, but in the face of their economic logic, their position seems untenable. Their survey of companies, however, indicated that grant-backs actually occur in only 0.5 percent of all agreements containing grant-back clauses (pp. 81-82).

The bundling of technology is justified by Wallender and Holland implicitly on a transactions cost basis. A supplier of technology generally creates integrated systems of technology. Purchasing components would result in mismatched elements. As well, the source company is in a better position to design the complete technical system than the purchasing firm (p. 82). The authors conclude by noting that there is a need for flexibility to be able to tailor the transfer agreement to each situation (p. 92). To prohibit certain practices will result in a contract which does not reflect the needs and capabilities of the parties. Either the transfer will not occur, or it will occur at a higher price.

Behrman (1976) reviews the same provisions with essentially the same arguments. The author stresses the fact that without grant-backs on some regulation of production, export, etc., the technology transfer will likely not occur (pp. 53, 56). Unfortunately the magnitude of this effect has not been estimated.

A review of the UNCTAD Code by Jeffries (1977) suggests that the elimination of restrictive business clauses will have an adverse effect on the amount of technology transferred. In a discussion of current legislation which seeks to control transnational corporations, the author notes that there are indications that this reduces the rate of technology transfer (pp. 328-29, n. 96, 105). Where regulation by one country is perceived to be too oppressive, the company simply moves its operations to a more lucrative jurisdiction (p. 330). The author suggests that effective change can only be accomplished by cooperation among developing countries and a recognition by transnational corporations that the environment for investment is changing (p. 330).

Even within the context of an international position on restrictive terms, such as the UNCTAD Code, there may be difficulties. The elimination of restrictions on the amount of output and exports would mean that every licence would create a potential international competitor for the licensor. A transnational corporation faced with this situation would compare its sales with the licensing revenue and either not grant the licence or grant it at a substantially higher price (p. 336). The author suggests that a better approach is that where sufficient skilled personnel are available, a subjective review of restrictive clauses should be made to compare the comparative harm of the clause with the benefit to the national economy.

Jeffries concludes by suggesting that the *administrative* infrastructure of each country and international cooperation are preferable tools. With more trained domestic personnel, stringent regulation may be possible in the long run. In the short run, working with transnational corporations through incentives and screening criteria will be more effective. In Jeffries' view, the eventual goal of any international action should be to create a convergence of all countries' laws (pp. 338-42).

In a note on the technology transfer laws of Mexico, Brazil and

Argentina, McGlynn (1976) refers to the reaction by the international business community to the prohibition of restrictive terms. At the time of passage of this legislation it was predicted by businessmen that the strict enforcement of such regulation would bring about a decline in investment in these countries. He notes, without reference, that preliminary statistics in the Ancom Group countries seem to demonstrate such a trend (p. 396). He concludes, however, by emphasizing the need for transnational companies to realize that technology transfer is a political as well as commercial issue, and that the developing countries have the bargaining instrument of their national sovereignty.

A Canadian perspective on the UNCTAD Code is given in Zuidwijk (1978). The author notes that Canada is in a unique position because of its position as a technology importer. The author notes that a number of studies, such as the *Working Paper on Patent Reform*, have suggested similar provisions to those in the UNCTAD Code. He concludes weakly by noting that Canada's interest does not necessarily coincide with the technology exporting countries; Canada is consequently a western nation in a position to understand the problems faced by developing countries (pp. 582-86).

The general perception of technology-importing countries is that the international patent system does not work for them. These arguments are recited by Fairley and Rowcliffe (1980). The free market in the spirit of the Paris Convention works well where all of the countries are producers of technology, and are swapping it. This system does not operate to the benefit of those who are almost completely consumers of technology. Further, they argue that transnational corporations are free to exploit the weaknesses of less developed countries by threatening to leave (pp. 224-25).

Some accommodation to the needs of less developed countries can be found in concessions to developing countries of the General Agreement on Tariffs and Trade. In patent law, however, until the Stockholm text of the Paris Convention was drawn up, there had generally been movement in the opposite direction, toward limiting technology transfer. It is argued by Fairley and Rowcliffe that the continued relative affluence of the developed countries is based on continued protection of their technological superiority (pp. 226-28), but such a position is superficial at best. If such countries were not able to protect their technologies, they would likely remain quite wealthy for some time because of their more highly valued factor endowments. And in the long run, in the absence of protection of intellectual property rights, all countries would probably be worse off and might then approach a more equal distribution of the world's wealth.

An ad hoc group examined various licensing practices in the OECD report on restrictive business practices. They started with the object of maximizing the benefits of international trade to developing countries.

This objective is, of course, a questionable starting point for analysis since it presumes that those countries should receive all or most of the gains from trade! They felt that several practices were likely to have adverse effects on these countries, and should therefore be prohibited. These practices were: restrictions requiring that the licensee not contest the validity of the patents involved in the licence; restrictions as to the use of the patent; restrictions on exports, and the charging of royalties after expiry of the patent. The justifications for these positions are not set out in the report. The most developed argument is that export restrictions should be prohibited because "ownership of a patent should not be used as a bargaining weapon to restrict exports" (p. 4).

Finnegan (1979) notes incidents of technology transfer being restricted by prohibitions. Argentina adopted a national law similar to the UNCTAD code, prohibiting many restrictive practices. It subsequently changed its law because of the reduction it had in technology transfer. Similarly, Chile pulled out of the Andean bloc because of the bloc's strict technology transfer laws. Unfortunately, Finnegan does not cite any sources for these observations, nor does he provide any estimates of the size of these reductions.

In his review of the patent system, Firestone (1971) discusses the restrictions on exports. He asserts that because Canadian firms are small, they do not have much bargaining power with large American firms. He implies that it is unfair that Canadian firms are dealing with foreign firms at such a disadvantage. He suggests that foreign firms be forbidden to discriminate against Canadian firms by barring them from exporting, where broad licences are given to firms in other countries (pp. 279-80). He notes that if exporting were to be permitted, cost per unit would fall because of economies of scale. As well, there would be benefits in terms of higher employment and income in Canada (p. 280). He concludes by suggesting that the *Combines Investigation Act* be amended to deal with these practices (p. 281).

An attempt to reconcile the positions of technology-importing countries and licensors is made in Wionczek (1980). Technology exporting countries feel that the most effective method of technology transfer is private sector licensing, service and management contracts. This leads them to advocate a minimum of government intervention. Less developed countries, however, argue that the technology trade at the international level cannot be viewed as the sum of private transactions. They contend that a transfer takes place not with the mere diffusion of private know-how, but with the incorporation of this know-how into the stock of available knowledge in such a way that the receiving society can use it for many purposes. Taken from this societal perspective, it is difficult for Wionczek to view private sector transfers as the sole source of economic growth (pp. 520.385-520.386). Although less developed countries recognize that technology is produced at great expense and acknowledge that

the owner deserves reasonable compensation, they feel that discrimination by owners in the form of pricing, most-favoured-nation status and restrictive business practices should be eliminated (p. 520.388). Wionczek calls for regulation because of the increased competition in international technology markets. Under competitive conditions, international technology trade is "obviously of interest not only to technology buyers, but to sellers as well" (p. 520.388).

A view from a less developed country is given in an unpublished Brazilian workshop paper by Singh, the bulk of which is essentially a licensing guide. With respect to territorial sales restrictions, the author notes that restrictions on exports are a grave disadvantage for less developed countries. He suggests that a reasonable compromise here is to provide for non-exclusive sales rights to all countries where the licensor has not given away exclusive rights to the technology (pp. 7-8). With respect to tie-ins, Singh notes that as a practical matter most firms in less developed countries desire to buy from the licensor because of the frequent unavailability of adequate inputs in the domestic market (p. 8).

There have been rumblings at governmental levels with respect to the desirability of prohibiting certain restrictive clauses. As noted in the *Working Paper* at p. 158, in 1974, Roy Davidson, senior deputy director of the Bureau of Competition Policy, Department of Consumer and Corporate Affairs, listed a number of restrictions, including field of use, exports, and level of production. Field of use and level of production were among those cited as examples of restrictions which went beyond the rights intended to be conferred by the patent.

The *Working Paper* went on to state that a cost-value analysis must be done to assess the impact on the competitive market versus the effect on incentive of each sort of restriction (p. 159). A test of whether the restriction is necessary in order to ensure that the patent right still serves as an adequate incentive was proposed (p. 160). The proposals lean toward permitting restrictive practices. The limits are: assigning future rights in inventions of unknown value (grant-backs) (s.80 (4)); and restrictions on the licensee's right to challenge the validity of the patent.

Conclusions

It is good to keep in mind that different policies create different incentives. This fundamental economic principle has been ignored all too often by the proponents of use-it-or-lose-it provisions and by supporters of proscriptions against restrictive terms in patent licences. In the end, any policy which reduces the rewards that foreign patentees can expect to receive will affect their behaviour: they will be less likely to patent their inventions in countries with such provisions, and they will be less willing to license their patents for the same royalty fees as they receive elsewhere if a particular country restricts the terms of the licence.

In other words, restrictions on the transfer of technology will serve as a deterrent to the transfer of technology. To the extent that such restrictions may have some real or imagined political pay-offs in the form of wealth enhancement of the owners or employees in certain types of industries, they may be desirable for some Canadians. Furthermore, to the extent that consumers may benefit from policies which reduce the Canadian value of foreign patents (e.g., compulsory licensing of pharmaceuticals), the policies may be desirable. But these benefits do have concomitant costs which should be considered before such policies are too warmly embraced.

These costs are in the form of deterred transfer of technology. Although they can be indicated theoretically and by example from countries that suffered a loss of technology transfer after instituting such policies, there are no solid estimates available about the size of these costs, especially in Canada. One can speculate about the size, some guesses may be well informed, but, until better empirical work is done, policies concerning technology transfer into Canada will have to be based on cost-benefit analysis, which has a wide margin for error. At this point, it is wise to keep in mind that many of the apparent theoretical differences which have emerged are in reality just idle chatter about unmeasured empirical magnitudes.

Not all of the controversy is empirical, however. Much of it also is the result of rent-seeking behaviour by different interest groups. By their very nature patents create rents in the hope that rent-seeking behaviour will induce more Canadian development and utilization of new technology. The rent-seeking behaviour that causes controversies about technology transfers is analytically similar. The only difference is that much of the rent seeking which we observe has less of a socially valuable by-product. Patents at least provide a spur to technical progress; political rent seeking is more wasteful.⁸

Much of the rent seeking one can observe concerning the transfer of technology comes from people who have a vested interest in protecting Canadian firms from competition in the development of technology. Their arguments favouring use-it-or-lose-it provisions are often couched in nationalistic terms of assuming the need for Canada to develop its own technology base and not to be dependent on other countries for its technology. These arguments are analytically identical to those seeking protection of any other Canadian industry which would eventually be put out of business by competition if we had freer trade, and they also should be rejected as ignoring the opportunity costs of using our scarce resources to produce something (such as technology) at comparatively high cost when they could be used more effectively in some other application.

A related type of argument favouring restrictive policies toward technology transfer is one which assumes that the imposition of restrictions

will have no repercussions. According to this argument it would be possible to appropriate some of the rents from foreign owners of patents, and they will not react significantly. Such an argument may be correct in the short run, but two types of long-run reactions ought to be taken into account before such restrictions are imposed. The first is that individuals and firms developing their technology elsewhere will become more reluctant to patent and license it in Canada if they expect to receive fewer rewards from doing so. As indicated earlier, the size of this effect is yet to be estimated reliably. The second repercussion, as noted by Whalley (1986), is more general. Countries which have a comparative advantage in the development of technology are unlikely to sit by idly while Canada, and perhaps others following our lead, weakens the value of their property rights in their patents. Retaliation is a plausible, if not likely, strategy for them to follow, as frequently happens when one country raises trade barriers. And the retaliation need not be closely related to technology. When Canada no longer allowed tax deductions for Canadians advertising to Canadian audiences via U.S. media, the United States retaliated by disallowing tax deductions for U.S. firms holding meetings and conventions in Canada. Similar retaliation would not be implausible in response to unilateral Canadian action reducing the value of U.S. patents. Hence, the only practical way that Canada can hope to make itself better off through changing policies toward technology transfer is through multilateral renegotiation of patent treaties and conventions, as it is currently attempting to do.⁹

The difficulty facing Canadian policy makers can be identified operationally with reference to the framework introduced at the beginning of this study. Within this framework, it will be recalled, there can be both publicly and privately created barriers to international technology transfer. The two most important policy issues concerning technology transfer involve both public and private decision making. In the case of use-it-or-lose-it provisions, the policies are ostensibly state-created instruments, designed to facilitate the pursuit of some economic and/or political goal(s). Yet the design of a use-it-or-lose-it policy must take into consideration the expected responses of private decision makers if it is formulated and enacted efficiently. Similarly, although vertical licence restrictions originate in the private sector, policies to affect the terms of licences must emanate from the public sector; and these policies must, in turn, take cognizance of likely private sector responses if they are to be effective. In both areas of concern, then, policy formulation must be informed by an understanding of potential private sector responses to different policies.

This conclusion by itself is not particularly startling. Its lack of novelty should not detract, however, from its importance. The simple fact that economic actors respond to policy changes in predictable ways has been

all too often ignored in the formulation of some of the policy suggestions analyzed in this study.

In many respects, continued multinational negotiations would seem ideal as a forum for continuing to work out mechanisms to encourage the international transfer of technology. Unfortunately, but not unexpectedly, different countries have different stakes in the negotiation outcomes. Hence, the negotiations have traditionally been more a forum for rent seeking and wealth redistribution than for facilitating technology transfer. The lack of unanimous accession to the Stockholm text of the Paris Convention, the ten-year stalemate of negotiations concerning Article 5A, and the recent agreement to cease talks indefinitely concerning Article 5A are all evidence that much of what is sought by some governments in these negotiations would involve making many residents of other countries worse off. The inability even to compromise across different issues brings into serious question whether any potential gains are possible from further multilateral negotiations at the present time on these issues.

The policy options left to Canada are consequently severely limited. Canada can gain from an increased flow of technology, especially if the flow can be accompanied by only small royalty payments. Of course policies designed to promote this result, which is really little more than an appropriation of intellectual property rights from foreign patentees, must be pursued with great care. It is reasonable to expect some responses to such policies from foreign patentees as well as from foreign governments. In addition, the policies will likely affect the distribution of wealth within Canada in ways that may or may not be desired. Policies which would make many consumers better off while provoking little retaliation would certainly be preferable to those which make only a few Canadians better off while others bear the costs of possible retaliations.

Notes

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1. A more detailed summary of compulsory licensing provisions in different countries is provided in OECD (1972).
2. An important general reason for similar legislation across nations hinges on the economic efficiency of much legislation. That which is inefficient is often subject to attack until it is changed. See, for example, Posner (1977).
3. Again, the reader is referred to Killing (1975) for the importance of know-how licensing in technology transfer.
4. If they are extremely averse to risk, it may be possible to make them better off by requiring foreign patentees to bear the risks of providing on-the-job training.
5. Even in these situations local technology producers and consumers may be better off, but those who distributed the imported technology or otherwise benefited will object, as also has happened in the Canadian pharmaceutical industry.

6. For a more complete discussion of patent licences and tie-ins, see Palmer (1984).
7. See *U.S. v. General Electric Co.* (S.C. 1926) and *U.S. v. Huck Mfg. Co. and Townsend Co.* (E.D. Mich. 1964).
8. See Posner (1975).
9. See Hay (1986).

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*Kenneth Norrie and John Sargent co-directed the final phase of Economics Research with David Smith

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